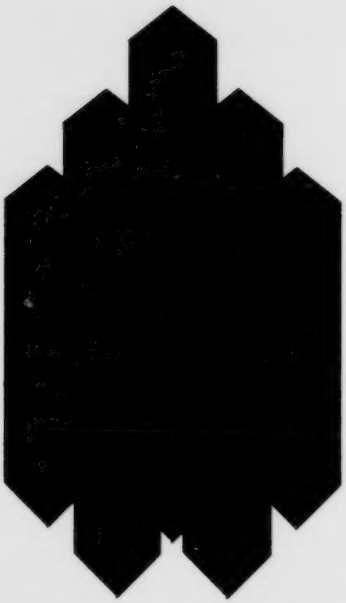
# *Tax Reform*

## *Perspectives on the* White Paper

*Policy Study No. 4*
*C.D. Howe Institute*



*edited by*
*Edward A. Carmichael*

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# Foreword

Ever since the Carter Commission reported its findings in 1966, many Canadians have felt that the tax system was in need of an overhaul. The urgency to undertake reform has increased over the past decade, as most major industrialized countries embarked on reforms that lowered individual and corporate tax rates, broadened tax bases, and increased emphasis on sales or value-added taxes. With the advent of tax reform in the United States in 1986, Canada could delay no longer.

On June 18, 1987, the federal government tabled the long-awaited *White Paper on Tax Reform*. Since that date, a wide discussion of its contents has taken place. In this study, the C.D. Howe Institute presents a series of authoritative papers by leading tax experts and economists that provide a reasoned assessment of the overall reform package and its economic implications.

In the first paper, Thomas J. Courchene assesses the major impact of the personal tax changes on individuals and argues that the government missed a key opportunity by not linking social policy changes with tax reform. In the second paper, R.D. Brown discusses the impact of the corporate tax changes on business. This is followed by David Y. Timbrell's assessment of the effects of the reforms on Canada's tax competitiveness with its major trading partner, the United States. In the fourth paper, Edward A. Carmichael examines the implications of tax reform on both federal and provincial finances. Lastly, John Bossons discusses the second stage of tax reform: the all-important sales tax change.

A common thread runs through these papers. There is a general endorsement of the main thrust toward lower tax rates and a broader tax base. There is considerable concern, however, about the uncoupling of sales tax reform from the changes to personal and corporate taxes. In particular, the authors emphasize the need for the government to re-examine the wisdom of delaying full revision of the federal sales tax system, which adversely affects Canada's competitiveness, particularly in light of a bilateral trade agreement with the United States.

The papers in this volume were prepared in August and September 1987, and formed the basis of the C.D. Howe Institute's submissions to the House of Commons Committee on Finance and Economic Affairs and the Senate Committee on Banking, Trade and Commerce. The authors' views proved influential not only in the reports of these committees but also in the

amendments to the *White Paper* proposals contained in the legislation presented to Parliament on December 16, 1987.

The Institute's Vice-President and Director of Policy Research, Ted Carmichael, coordinated the project and acted as editor of the final volume. Barry Norris, Director of Publications, did the technical editing and Cordelia Sharpe efficiently prepared the manuscript.

The conclusions presented here are those of the authors and do not necessarily represent the views of the Institute's members or directors.

Maureen Farrow
President

# Perspectives on the *White Paper*: An Overview

***Maureen Farrow***

On June 18, 1987, Finance Minister Michael Wilson unveiled the federal government's long-awaited *White Paper on Tax Reform*. The tax reform proposals have since been widely debated, particularly in hearings before two parliamentary committees during the late summer and autumn of 1987. In December 1987, following the preliminary reports of these committees, the Minister of Finance tabled tax reform legislation to effect changes to the personal and corporate income tax systems in 1988.

During the 1980s, most of the larger industrialized countries have undertaken major reforms of their tax systems. The general thrust of tax reform internationally has been to lower individual and corporate tax rates and to broaden tax bases. From a Canadian perspective, this international trend culminated in the U.S. tax reform of 1986, which overhauled that country's income tax system in a way that significantly lowered personal and corporate tax rates.

The U.S. tax reform posed a twofold challenge to Canada. First, it raised concerns that, other things being equal, Canada would become a less attractive location in which to work and invest because the lower U.S. tax rates might place Canadian businesses at a competitive disadvantage in international trade.[1] While such a situation could produce competitive

[1]Concerns about Canada's tax competitiveness are discussed in Robert D. Brown, *Tax Reform in a New Light*, C.D. Howe Institute Commentary no. 13 (Toronto: C.D. Howe Institute, January 1987), p. 6.

difficulties in the short term, over the longer term one would expect that a depreciation of the Canadian dollar would restore trade competitiveness. Second, the U.S. reform increased the possibility that individuals and businesses operating in both Canada and the United States would undertake tax planning strategies that would shift income to the United States, where it would be taxed at lower rates, and shift deductions to Canada, where the tax savings would be larger. The net result of such tax planning would be to erode the Canadian tax base, perhaps significantly, over a period of years.

Improving Canada's tax competitiveness relative to the United States, therefore, was a major objective of the *White Paper*. It was not the only objective, however. Others included improving the *fairness* of the tax system, increasing the internal *consistency* of personal, corporate, and sales taxes and the consistency of the overall tax system with other government programs, enhancing the *reliability* of the tax system as a stable source of federal revenues, and increasing its *simplicity*.[2]

In the 1960s, the federal government twice attempted to overhaul Canada's tax system, without much success. A fierce national debate and the resulting long lags between the Carter Commission's tax reform proposals in 1966 and Finance Minister Edgar Benson's *White Paper* in 1969 led to a significant dilution of the original proposals. Similarly, Finance Minister Allan MacEachen's tax reform proposals of 1981, which were based on little prior consultation, created such a public outcry that the government was forced to abandon several major aspects of the proposed reform.

The 1987 *White Paper* had been expected for almost a year and was based on widespread prior consultation. Detailed proposals for corporate tax reform had been unveiled in the May 1985 budget, and the broad thrust of the personal and sales tax reform proposals had been generally anticipated. Therefore, the first stage, which proposes reform of the personal and corporate income tax systems, contained few major surprises and will be legislated with few major changes. A major disappointment of the *White Paper*, however, was the decision to delay reform of the sales tax. This second stage of the overall reform was presented without a detailed timetable for consultation, decisionmaking, or implementation. Since the second stage is widely viewed as promising more significant economic benefits to the Canadian economy, its indefinite nature leaves a large question mark in any evaluation of the overall advantages of the tax reform package.

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[2]Department of Finance, *The White Paper: Tax Reform, 1987* (Ottawa, June 18, 1987), pp. 24-25.

In this publication, the C.D. Howe Institute draws together perspectives on the *White Paper* prepared by a group of five economists and tax specialists. Their papers analyze the reform proposals, present a critical assessment of the impact of the reform on individuals, businesses, and government finances, and highlight some of the opportunities that the federal government missed.

Thomas J. Courchene leads off with an assessment of the impact of the personal tax changes on individuals. He also discusses a key opportunity missed, that of linking social policy changes with tax reform. In the second paper, Robert D. Brown discusses the impact of the corporate tax changes on business. Next, David Y. Timbrell assesses the effects of the reform proposals on Canada's tax competitiveness with its major trading partner, the United States. In the fourth paper, Edward A. Carmichael examines the effects of tax reform on federal and provincial finances. Finally, John Bossons discusses the second stage of tax reform and the options for achieving a successful reform of the federal sales tax.

A common thread runs through these papers. There is a general endorsement of the main thrust toward lower tax rates and a broader tax base. The authors express considerable concern, however, about the uncoupling of sales tax reform from the changes to personal and corporate taxes. All five emphasize the need for the federal government to re-examine the wisdom of delaying full revision of the federal sales tax system, a system which adversely affects Canada's competitiveness, particularly in light of the Canada-U.S. Free Trade Agreement.

### *Tax Reform: The Impact on Individuals*

In his discussion of personal tax reform, Tom Courchene argues that the overall tax reform package passes the acid test of improving horizontal and vertical equity. Vertical equity is enhanced by removing 800,000 low-income Canadians from the tax rolls and by replacing personal tax deductions with tax credits. Horizontal equity is enhanced by substantially narrowing the differential tax treatment of personal income from different sources. The reform reduces the preferential treatment of income derived from investments relative to income derived from wages and salaries. Courchene argues, however, that a two-stage tax reform process considerably dilutes the logic of, and limits the potential for, increasing the overall fairness of the tax system.

Looking at the personal income tax reform proposals, Courchene points

out that marginal tax rates for middle-income Canadians will be increased. This result may be reversed in the second stage, particularly if revenue generated from the replacement of the existing manufacturers' sales tax (MST) with a broadly based, multistage sales tax is used to lower marginal personal tax rates and if it is accompanied by an enriched refundable sales tax credit.

The *White Paper* proposes to reduce the number of personal tax rate brackets from ten to three. Courchene makes the interesting observation that it is now feasible to consider moving to a single tax rate. This is because the degree of progressivity in the income tax system is no longer solely a function of marginal rates once one embeds refundable tax credits and clawbacks of social benefits in the personal tax system. Therefore, Canada could move to a flat, yet progressive, tax rate structure that would improve integration of the personal and corporate income tax systems and eliminate the need for income averaging.

Turning to the tax treatment of the elderly, Courchene demonstrates that tax reform will benefit the lower-income elderly, but, more importantly, benefits will remain too generous for the elderly rich. He argues that a more focused approach could generate revenue gains that could be reallocated to the elderly poor. This is an important argument in light of both the increasing affluence of the elderly and Canada's aging demographic profile.

The tax reform proposals take an important step toward integrating tax and social policies by converting deductions and exemptions to credits. It paves the way for making credits refundable and income tested, and thus moves in the direction of a guaranteed annual income. Courchene argues persuasively, however, that the government missed a major opportunity to undertake a more significant overhaul of social policies as part of the tax reform.

Courchene suggests that, in total, the proposals represent a substantial attack against Canadians who invest and that the provisions relating to investment income require a major rethink.

In spite of these concerns, Courchene argues that the total package moves Canada's tax system in the right direction. However, the potential implications of breaking tax reform into two stages are serious as long as there is doubt that the government will successfully pursue and conclude the second stage of the reform plans.

### *The Effects of Tax Reform on Business*

Once the United States introduced corporate tax reform and substantially

lowered tax rates on U.S. businesses, corporate tax reform became necessary in Canada to avoid a substantial erosion of the Canadian tax base. Without corporate tax rate reductions, Canada risked seeing the movement of businesses to the United States and the reorganization of multinational corporations' affairs in order to shift income to the United States, where tax rates were lower, and to shift deductions to Canada, where higher tax rates would make them worth more.

The philosophy behind the tax reform changes is to move toward a more "level playing field", by cutting corporate tax rates and reducing some business incentives and tax breaks so that virtually all profitable corporations pay some tax. The broader base, reduced incentives, and lower rates are designed to reward success, not effort.

Bob Brown, in his assessment of the impact on business, recognizes that a more neutral and noninterventionist system is more appropriate for Canada. Brown argues forcibly, however, that the number one concern for Canada is the lack of a "clear schedule for implementing the badly needed reform of the commodity tax system." The replacement of the MST with a broadly based, multistage sales tax would avoid the pyramiding of tax on business inputs, remove the penalties on Canadian-made goods that must compete with foreign-produced goods at home and abroad, and eliminate distortions caused by the random burden of the present sales tax. Brown argues that Canadian business was prepared to sacrifice much in exchange for the removal of this antiquated and harmful commodity tax. Business made its sacrifices, in his view, but did not obtain a detailed sales tax reform plan in return.

Another set of concerns relates to the failure of the reform package to provide relief from the effect of inflation within the corporate tax system and the lack of full integration between personal and corporate taxes.

Overall, the tax reform package shifts the burden of taxation from individuals to business. Brown points out that, according to the Organisation for Economic Co-operation and Development, Canadian corporations already bear a higher tax share than the average for the industrialized countries, both as a percentage of GNP and as a percentage of total taxes. However, tax reform still leaves the domestically controlled, small private company in Canada with the most favorable tax regime among the industrialized countries.

Brown also points out that the most important tax change bearing on the corporate tax base is that relating to the treatment of capital costs. The key allowance on manufacturing and processing equipment would be cut to a declining balance rate of 25 percent over a four-year transition period,

instead of the present three-year straight line writeoff. Furthermore, after 1989, depreciation would be allowed only when the asset is put in use. Brown argues that these changes slow down writeoffs and raise effective investment costs on major new projects. In fact, for the first time in decades, the effective depreciation rates on most machinery and equipment in Canada would be below those in the United States and would negatively affect the attractiveness of new business investment in Canada. This is of particular concern for the capital-intensive sectors, whereas the tax reform package provides relief to the growing services sector.

### *Tax Reform: Effects on Canada's Tax Competitiveness with the United States*

David Timbrell examines how the proposed tax reform would affect Canada's tax competitiveness vis-à-vis the United States, its major trading partner. He looks at two distinct types of effects: those created by differences in marginal corporate tax rates and those created by the impact on the overall tax burden on an industry.

Timbrell analyzes tax competitiveness between Canada and the United States by developing several indicators. First, in a comparison of statutory corporate tax rates, he shows that a typical Canadian manufacturing business had a 4 percentage point rate advantage over its U.S. counterpart in 1986, that it would have a rate disadvantage of 2 percentage points in 1988, but that by 1992, when the Canadian reform is fully implemented, Canada would again enjoy a rate advantage of 3 percentage points. Second, Timbrell compares the present values of tax deductions associated with capital expenditures. His results indicate that the reductions for manufacturers' assets are similar in both countries, that the U.S. pre-reform advantage for resource extraction assets has been reversed in favor of Canada, and that the reforms enhance Canada's pre-reform advantage for R&D expenditures. Third, Timbrell constructs estimates of pre- and post-tax reform discounted cash flows for a typical manufacturing investment in Canada and the United States. His results suggest that, after tax reform, Canada generally would maintain the slight advantage it enjoyed prior to the U.S. and Canadian reforms. He also finds that the combined effect of tax rate and tax base changes is to reduce the discounted value of after-tax cash flows on a typical investment by about 5 percent in both countries.

Another aspect of tax competitiveness relates to the influence of tax reform on the most favorable tax location for entrepreneurs and executives. Overall, Canada's personal tax rates will remain somewhat higher

than in the United States, but, in Timbrell's view, the jury is still out on the impact this will have.

The broad conclusion of Timbrell's analysis is that, on balance, the first-stage reforms are sufficient to prevent shifts in activity or significant erosion of Canada's tax base that might have resulted following U.S. tax reform had Canada not responded. Timbrell argues, however, that Canadian competitiveness could be enhanced substantially by the proposed federal sales tax changes contained in the second stage of the reform.

### *Tax Reform: The Impact on Government Finances*

Throughout the 1980s, the size of the federal deficit has been a major concern, as it increases Canada's vulnerability to external shocks and limits the flexibility of government to use fiscal policy to stabilize the economy. It is within this context that Ted Carmichael argues that tax reform and deficit reduction should be viewed as complementary instruments for meeting the economic challenges Canada faces. He argues, however, that if tax reform is not accompanied by deficit reduction, a deteriorating fiscal position could offset the potential benefits from reform. Tax reform, in fact, should be viewed as one element of a strategy to reduce the deficit in the fairest and least painful way. By strengthening the economy and broadening tax bases, tax reform could be a major part of the solution to the deficit reduction challenge.

Carmichael argues that the fiscal projections that accompanied the *White Paper* do not inspire confidence that the federal government will meet its stated objective of "continuing, sizable, year-over-year reductions in the deficit." He questions the government's underlying economic projections of ten years of uninterrupted growth without any resurgence of inflation. He notes that the deficit projection does not provide for growing spending pressures for agricultural assistance, defense spending, child care, and other programs. He also questions the accuracy of the estimated revenue impact of the tax reform proposals, which is based on many assumptions about how individuals and firms will respond. Therefore, he maintains, the risk remains that federal deficits and debt could be higher than the *White Paper* projects.

Tax reform will also affect provincial government finances. In the early years of the new tax system, all provinces will lose more in personal tax revenue than they gain in corporate tax revenue. In later years, those provinces with a relatively large share of corporate taxes will benefit from greater tax revenues as base broadening takes hold. This means that the

reform proposals will have a larger positive impact on provincial finances in Ontario and Alberta, which generate a relatively large share of corporate income, and a negative impact in Quebec, where corporate tax rates are lower. As is the case at the federal level, the first stage of tax reform will not help those provinces with chronic large budget deficits to improve their fiscal situation.

Carmichael argues that, because of the serious nature of federal and provincial finances, Canadians should view deficit reduction and tax reform as complementary. Therefore, a second stage comprising reform of the federal sales tax and further reduction in personal and corporate tax rates should be pursued with urgency, as the positive impact on the economy and the potential for improved government finances would be significant.

### *Sales Tax Reform: The Postponed Part of the Package*

A common theme throughout the papers is that the uncoupling of the sales tax reform from the reform of personal and corporate taxes is undesirable and that, in fact, sales tax reform offers the most significant potential economic benefits.

In the final paper, John Bossons points out that the current federal sales tax is a hidden tax on manufacturers that dates back to the 1920s. Many consumers do not realize how much the tax increases the prices they pay. The federal government raises $13 billion annually — almost 20 percent of federal tax revenues — from this tax. Generally, the tax is recognized as arbitrary and difficult to administer and enforce. Because the current sales tax penalizes exports and subsidizes imports, reform is crucial to improving Canada's ability to compete internationally, particularly in light of the free trade agreement with the United States.

The first stage of tax reform moves in the wrong direction by expanding the base and increasing economic problems associated with the MST. The second stage proposes three alternative approaches for a new multistage sales tax: a national sales tax, which would replace both the current federal sales tax and the existing provincial retail sales taxes, a federal-only goods and services tax, and a federal-only value-added tax (VAT). Discussions are currently under way on the advantages and disadvantages of each of these reform options, but the timetable for achieving results is highly uncertain, largely because of public concerns about the redistributive effects of sales tax alternatives.

Bossons argues that it would be better to implement immediately a federal VAT that exempts food and prescription drugs, and that is accompa-

nied by a refundable tax credit for low-income households. If the provinces can agree, an integrated federal-provincial VAT should be introduced. But in any event, delays should be minimized and the two levels of government should agree to a solution to sales tax reform. It is Bossons' contention that Canada should not permit discussion of the details and impact on particular sectors to obscure the main issue, namely, that any one of the sales tax proposals would serve Canadians better than the existing manufacturers' sales tax. He argues that the first step in sales tax reform is to make the federal sales tax fairer, less arbitrary, and less of a burden on the economy. The integration of federal and provincial sales taxes is desirable, but could be undertaken as a second phase of sales tax reform.

### *Conclusion*

All five authors agree that it is time to overhaul Canada's tax system and that the overall direction the *White Paper* takes is appropriate. All agree that the indefinite delay on sales tax reform is both unnecessary and harmful to the Canadian economy. Failure to proceed with the second stage of reform will harm Canada's international competitiveness, make more difficult the adjustment to free trade with the United States, and expose Canada to the risk of a fiscal crisis. The first stage of the reform appears likely to be implemented with only minor modifications. It is now time to get on with sales tax reform.

# Tax Reform: The Impact on Individuals

*Thomas J. Courchene*

## Introduction

Individuals ultimately bear the burden of all taxes. In principle, therefore, all aspects of the federal government's tax reform proposals are relevant when assessing their impact on individuals. Obviously, such a detailed assessment is well beyond the scope of this paper. Accordingly, the principal focus is on the personal income tax reforms, with selective emphasis on the manner in which the proposed sales tax and corporate tax changes, interacting with the personal tax system, would affect individuals.

The paper proceeds as follows. The first section places the reform proposals in a conceptual framework. This is more difficult than one might at first imagine, because, the *White Paper* does not devote space or effort to formulating a "theory of tax reform". It contains no analysis of the relative merits of income and expenditure taxes. There is little discussion of the optimal tax mix across corporate, personal, and sales taxes. Except for obvious influences emanating from U.S. tax reform, there is no detailed comparative analysis of tax practices in other jurisdictions nor, for that matter, is there adequate recognition of the implications of an open economy on designing tax reform. Nonetheless, the *White Paper* and its related documents do incorporate, explicitly or implicitly, certain underlying principles. An elaboration of these principles provides the backdrop for the remainder of this analysis.

The analysis proper begins with a discussion of the main elements of the first-stage proposals for reform of the personal income tax and the implications of these proposals for the behavior of marginal tax rates. This is followed by a comparison of marginal rates before and after reform. Of considerable interest here is that, under the first-stage proposals, marginal tax rates for middle-income Canadians would exceed current rates — and, under reasonable assumptions, so would the new *average* tax rates. This leads to a discussion of personal income tax proposals contained in the second stage of the reform process, since a major part of their rationale is to generate tax cuts for middle-income Canadians.

The analysis then continues with an examination of the implications of the interaction between the first and second stages of the reform process. To anticipate the analysis, the conclusion is that the proposed staging is inappropriate. Not only is the second stage essential for meaningful tax reform but, by itself, the first stage is likely to run up against fiscal (deficit) constraints.

The discussion then focuses on specific concerns about income distribution, including the tax treatment of 18-year-olds and the elderly, and addresses the tax treatment of investment income and the integration of the personal and corporate income tax systems.

The final substantive section examines how tax reform is likely to affect relations between the federal government and the provinces. A brief conclusion completes the analysis.

## The Thrust of the Reforms

On the covers of the tax reform documents appears the phrase "lower rates, fairer system", which the federal government chose to sum up its approach to tax reform. One can go beyond this two-pronged approach, however, and posit that the underlying thrust of the reform package appears to have three facets:

- to enhance *horizontal equity* — that is, equal treatment of equals;
- to modify *vertical equity* in the direction of increasing progressivity, particularly for lower-income groups; and
- to enhance *neutrality* vis-à-vis the tax systems of Canada's major trading partners, thereby serving to increase Canadian competitiveness.

These goals are not always compatible. For example, efforts to enhance the progressivity of the tax structure have to face the reality that the United States has lowered its top marginal rates dramatically so that, almost of

necessity, some benefits (on neutrality grounds) will have to accrue to upper-income Canadians. Moreover, these goals are not always honored, as this analysis demonstrates. Nonetheless, it is instructive to address the reform thrusts for personal, corporate, and sales taxes in terms of these principles.

### *Personal Income Tax*

The net effect of the reform proposals on personal income tax would be a ***substantial narrowing*** of the differential tax treatment of income, regardless of source. This is to be achieved by:

- capping the lifetime capital gains exemption at $100,000, rather than at $500,000;
- increasing the percentage of taxable capital gains that must be brought into income, from the current 50 percent to 66⅔ percent in 1988 and 75 percent in 1990;
- removing the $1,000 interest exemption;
- cutting back on allowances — for meals and cars, for example — relating to income from self-employment; and
- eliminating or reducing various tax shelters, such as MURBs.

Compared with the *status quo*, those whose income derives mostly from wages and salaries would pay less tax, while those whose income derives mainly from investments or who are self-employed would pay more or, at least, would benefit less from tax reform than would salaried individuals with comparable overall incomes. This is not quite the "dollar is a dollar is a dollar" approach that the Carter Commission took, but it is unmistakably a move in the direction of enhancing horizontal equity.

The proposed conversion from exemptions to credits, by itself, clearly would increase the progressivity of the personal income tax. To be sure, progressivity would be enhanced even further if all the credits were refundable. Nonetheless, the new credit system would embody a greater degree of progressivity than does the existing deduction system. While the conversion of exemptions to credits would make lower-income taxpayers better off, higher-income taxpayers also would benefit from the reform process because of lower overall marginal tax rates. But this does not alter the point that the move from exemptions to credits would enhance progressivity.

Finally, lowering marginal rates and broadening the tax base would bring the Canadian system more in line with that of the United States and, indeed,

with those of most other Western countries, thereby neutralizing to some extent the impact of taxes on the international allocation of capital and labor.

### *Corporate Income Tax*

The proposed changes to the corporate tax regime would reduce the variations in tax rates that firms in different sectors pay. Firms that now pay below-average taxes generally would pay more, while those that pay above-average tax rates would pay less. Part of this leveling out process would come about by provisions that would reduce the number of profitable corporations that pay no tax. As a result, tax considerations would be less important in the allocation of investment funds across sectors. In other words, like personal taxes, corporate taxes would move toward enhancing horizontal equity. However, one has to be somewhat careful here. In principle, it is hard to argue against a system that strives to ensure that market considerations, rather than tax incentives, drive investment across sectors. And there would be little trouble with this approach in a closed economy. In an open economy, however, this concept could easily run into problems if other countries adopt a different approach and if the industries in question are mobile internationally. The proposal to increase dramatically the insurance industry's tax burden may be a case in point. This tax increase can be rationalized partly on domestic horizontal equity grounds: the insurance industry has paid very little in the way of taxes over the years, and appears resigned to bearing a more equitable share. But if Canada were to tax the insurance sector more heavily than do other countries, the net result could be an outflow of insurance capital and services.

The concept of progressivity is not really all that well defined when it comes to the corporate tax system, except perhaps in terms of the integration between corporate and personal taxes, which is dealt with later. Some might argue that the preferential corporate rates for small business embody elements of progressivity. Perhaps, but in my view progressivity relates to the impact on individuals; nothing prevents millionaires from owning small businesses. As with the personal tax system, lowering marginal rates and broadening the base would bring corporate taxation more in line with the U.S. system. (As discussed in more detail in other contributions to this volume, however, this positive impact could be offset, in some industries, by the proposed changes in capital cost allowance rates and by changes in the "put-in-use" rule, which may delay the starting date for claiming this allowance.)

### *Sales Taxation*

The existing manufacturers' sales tax (MST) is highly distortionary. Its base is rather narrow, which means that the tax system treats sectors that must pay the MST quite differently from those that do not. Even in the included sectors, effective tax rates vary considerably across products. The first-stage tax reforms would broaden the MST base to some extent. It is not at all certain, however, that these first-stage reforms would be sufficient to improve the horizontal equity of the tax in a significant way. As part of the second-stage reforms, however, the government has proposed three alternatives to the present MST, all of which would broaden the base dramatically and reduce the tax rate.[1] The longer-term reform proposals, therefore, would seem to hold out the promise of real improvement in the horizontal equity of sales taxation.

Sales taxes typically are viewed as regressive. In the current system, the presence of refundable sales tax credits reduces this regressivity somewhat. The first-stage reforms include provisions for small increases in these tax credits to offset base broadening, which further addresses the concern about regressivity. It would appear, however, that in the second stage the government intends to increase substantially refundable credits to low-income Canadians. The proposals do not incorporate dollar values for these credits, presumably because that will depend on whether such items as food and clothing are included in the sales tax base. For present purposes, it is sufficient to note that concerns about the regressivity of sales taxes feature prominently in the proposals, as do measures to reduce it.

Finally, converting from an MST to a value-added or multistage tax, as the *White Paper* proposes, would remove a significant distortion that affects both exports and imports. Under the existing system, the MST is applied to exports — amounting to roughly $2 billion in tax revenue — but not to manufactured imports. Thus, the tax puts Canadian exports at a competitive disadvantage. The second-stage reforms, however, would rebate the tax on exports and impose it on all imports, thus ensuring a more neutral tax treatment of Canada's international trade.

### *Summary*

In terms of embodying a consistent overall approach across personal, corporate, and sales taxes, the reform proposals appear to merit high

[1]For a detailed discussion of these alternatives, see the paper by John Bossons in this volume.

marks. The common thrust is toward enhancing horizontal equity (equal treatment of equals), increasing progressivity, and approaching neutrality with respect to the tax regimes of Canada's major trading partners. This assessment, however, views the two reform stages as an integral package. To be sure, the first stage shares most of these characteristics, but the degree to which they can be implemented without the second stage is considerably constrained, if not effectively stymied. Let us now examine some of these concerns in more detail.

## Changes to the Personal Income Tax under the First-Stage Reforms

The first-stage reform proposals include a number of significant changes to the personal income tax. The Appendix to this paper, a Department of Finance handout that did not receive the distribution it warrants, is a nearly complete summary of these changes. It also includes pre- and post-reform illustrative calculation sheets that enable the reader to determine the effects the reforms would have on the amount of tax he or she pays. The handout is reproduced *verbatim*, including references to the tax reform documents and the 1986 income tax guide, with only minor annotations for the sake of clarity. While it is essentially self-explanatory, a few comments are in order.

First, the reforms would reduce the ten existing tax brackets to three: 17 percent for up to $27,500 of taxable income, 26 percent for taxable income between $27,500 and $55,000 range, and 29 percent for taxable income beyond $55,000.

Second, most deductions would be converted to credits and most at the 17 percent tax rate. Under the current system, for example, the $1,000 pension income deduction for the elderly is worth $340 for taxpayers in the highest income bracket but only $60 for those in the lowest bracket. Under the new system, all taxpayers would be able to offset $170 of the federal tax payable. For those in the lowest new tax bracket (17 percent), the credit essentially would be identical to a deduction. Those in the new top bracket (29 percent), however, obviously would be worse off. Moreover, those in the lowest bracket would gain even more, relatively, from deductions that are converted to credits at a rate higher than 17 percent. For example, the current basic personal tax exemption is $4,270; the post-reform tax credit would be $1,020, which corresponds to an effective conversion rate of 22.7 percent.

Third, the new system would eliminate several important deductions.

There would no longer be tax credits for the $500 employment expense deduction, the $1,000 interest and dividend income deduction, or the deduction for dependent children age 18 and over. On the other hand, the tuition and education credit would be made transferable to a parent or even a grandparent.

Note that these examples refer only to federal taxes payable. Provincial taxes payable would be obtained by multiplying the basic federal tax by the appropriate provincial tax rate — for example, 50 percent for Ontario. In effect, this would mean that, in the case of Ontario, the value of the provincial tax credits would be 50 percent of the federal credits.

As a final introductory item, it is important to recognize that the current and proposed tax regimes calculate "taxable income" quite differently. Consider a family of four with one wage earner, two children under age 18, and no contributions to a Registered Retirement Savings Plan. Under the new system, this family's taxable income effectively would equal its total income — that is, the family would deduct nothing from its total income. (On the calculation sheet for the new system in the Appendix, this assumes that line 23 equals line 12.) Under the current system, this family is able to deduct $9,450 — comprising the basic and spousal exemptions, exemptions for two children under 18, and the $500 employment deduction. The family's taxable income thus equals total income *less* $9,450. Suppose that its total income is $27,501. Under the existing system, its taxable income is $18,051 — $27,501 less $9,450 — and the applicable marginal tax rate is 20 percent. Under the new system, however, the family's marginal tax rate would be 26 percent. Thus, while the fact (elaborated on later) that, over a considerable income range, marginal tax rates for middle-income Canadians would be higher under the new system should not come as a surprise, it certainly did not feature prominently in the official tax reform documents.

### *The New Marginal Tax Rate Schedule*

The new federal marginal tax rates that Canadians would face are not as straightforward as they might at first appear. As noted, these rates are 17 percent, 26 percent, and 29 percent. For Ontario residents — with a 50 percent provincial tax rate and federal tax — these would convert to 25.5 percent, 39 percent, and 43.5 percent. One complication relates to the 3 percent federal surtax, which applies only to the federal rates, but I shall ignore this.

The more interesting complication relates to the claw-back of refundable federal tax credits. The new refundable sales tax credit would be $70 per

adult and $35 per child under 18. This credit would begin to be taxed back at 5 percent once net income reached $16,000. (Net income essentially would equal taxable income except for those taxpayers with capital gains or losses — see lines 19 through 22 of the calculation sheet for the new system in the Appendix.) The refundable child tax credit would be $524 per child, and would begin to be taxed back at 5 percent once income exceeded $24,020. This implies that it would effectively take $10,500 of income — that is, 524/0.05 — to tax back the credit for one child. The taxback rate would not be stacked, so that it would take $21,000 — that is, 2 X $10,500 — of income beyond $24,020 before a family with two children would have its refundable tax credit taxed back, and so on.

Consider a family of four whose only source of income is employment. Its tax credits would be $1,020 for the wage earner, $850 for the spouse, and $65 for each of the two children. Cutting corners a bit — that is, ignoring the Canada Pension Plan and unemployment insurance tax credits — the family would pay no *net* federal tax until the threshold level of about $18,500.[2] Thus, once this threshold is reached, the family would face the following federal marginal tax rates:

- 22 percent — reflecting the 17 percent statutory rate plus the 5 percent taxback of the refundable sales tax credit — until the refundable credit runs out (that is, to $20,200);[3]
- 17 percent from $20,200 to $24,020, when the child tax credit would begin to be taxed back;
- 22 percent from $24,020 to $27,500, when the 26 percent marginal rate would kick in;
- 31 percent — that is, the 26 percent marginal rate plus the 5 percent taxback rate of the child credit — until the child tax credits are exhausted, which would occur at $45,020 (that is, $24,020 plus $21,000 of income to exhaust two child tax credits);
- 26 percent from $45,020 to $55,000; and
- 29 percent from $55,000 and beyond.

Thus, under the new system, rather than the straightforward rates that one might have expected, the federal marginal tax rates for a family of four

[2]A complicated calculation underlies this number. It represents the income level at which the tax that is owed equals the value of the refundable credits — that is, the level at which the family begins to pay some *net* positive federal tax. Precise calculations are not really that important to illustrate the point at issue.

[3]The refundable sales tax credit for two adults and two children equals $210. At a 5 percent taxback rate, it takes $4,200 to reduce the value of the credits to zero. Given that the credit begins to be taxed back at $16,000, it is exhausted at $20,200.

are 22, 17, 22, 31, 26, and 29 percent. Moreover, if there were three children in the family, the refundable child tax credit would be exhausted at $55,520 rather than at $45,020 — that is, the family would *never* be in the 26 percent middle-income tax bracket, in the sense of facing a 26 percent marginal tax rate. For this family, the federal marginal rate schedule would be 22, 17, 22, 31, 34 — for the $520 beyond the $55,000 level, when the 29 percent statutory bracket would take hold — and 29 percent.

If this is not sufficiently complicated, officials of the Department of Finance have testified before the House of Commons Standing Committee on Finance and Economic Affairs (the Blenkarn Committee) that, under the second stage, the refundable sales tax could be in the neighborhood of $500–700 for a family of four, depending on whether a sales tax is imposed on food. What is even more confusing, these officials suggested that the threshold income level for clawing back the refundable sales tax credit could be raised to about $25,000. But this is where the claw-back of the refundable child tax credit would take effect. Is the intention, then, to combine them for a 10 percent addition to the statutory rates? Or are they to be taxed consecutively, in which case no family of four would ever face a 26 percent marginal tax rate?

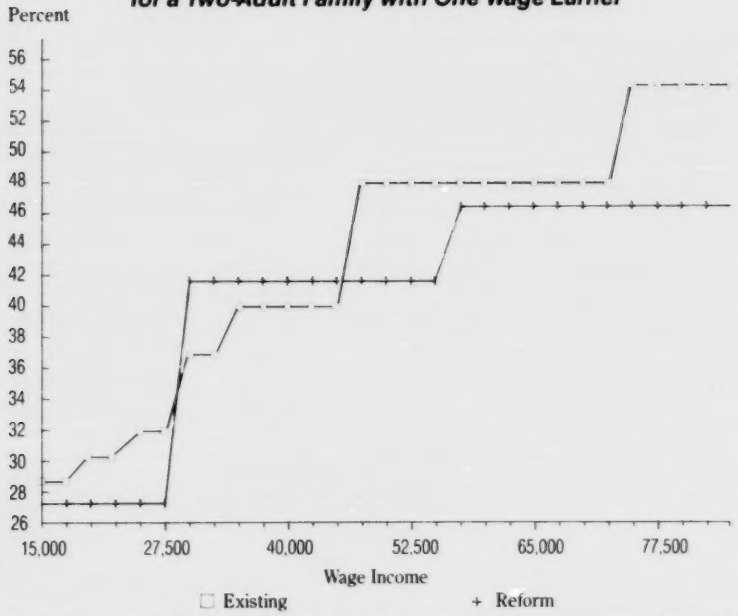
To be sure, these marginal rate anomalies also characterize the existing system. Nonetheless, they prompt the following observation: since tax reform would reduce the number of statutory rates from ten to three, why not go all the way and have only *one universal marginal rate*?

Let me elaborate. Suppose there was a universal marginal rate of 25 percent. *All taxpayers would face this rate*. It would be *inclusive* of any claw-back rates on refundable credits. This would amount to an increase in tax rates for those in the lowest income bracket. But this could easily be offset by enhancing either the refundable tax credits in the first-stage reforms or the refundable sales tax credits in the second stage. It would also be a gift to higher-income Canadians since they would face a 29 percent marginal tax rate under tax reform. To offset this, why not follow the U.S. experience and, after some income threshold — say, $70,000 — tax back at 5 percent *all* the nonrefundable tax credits, including personal and spousal credits? For high-income Canadians, therefore, the *average* as well as the marginal rate would be 25 percent.

It is important to recognize that the degree of progressivity in the income tax system is no longer a function of marginal rates once one embeds refundable credits with "inclusive" claw-backs in the tax system. Thus, Canada is within striking distance of having a *flat* (yet progressive!) marginal tax rate structure. Among other features, this would greatly

**Figure 1**

***Pre- and Post-Reform Marginal Tax Rates for a Two-Adult Family with One Wage Earner***




Source: Marion Wrobel, "Tax Reform and Its Impact on Families," (Ottawa: Library of Parliament, 1987), p. 3.

facilitate the integration of the personal and corporate income tax systems. Moreover, it would eliminate the need for income-averaging provisions.[4]

## Marginal and Average Tax Rates: Pre- and Post-Reform

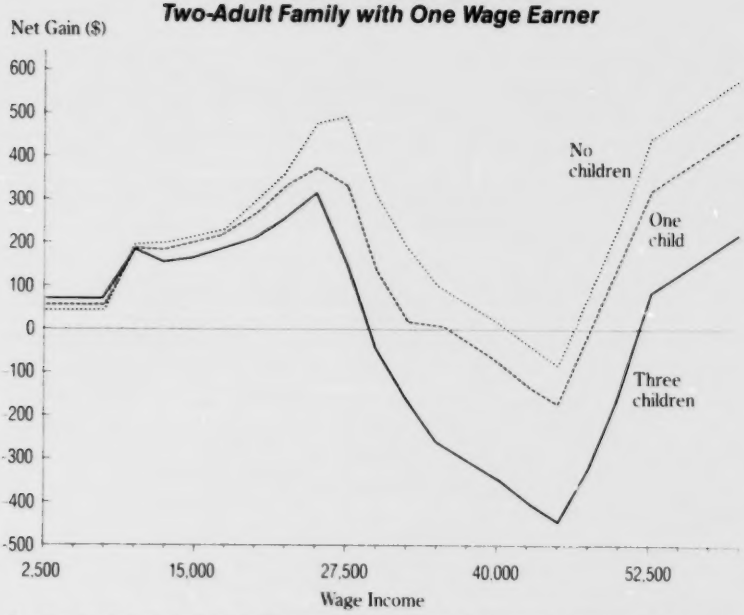
So far, the analysis has focused on the proposed new system. It now shifts to a comparative analysis of the current and proposed systems.

Figure 1 compares marginal tax rates under the two systems for a family of two with one income earner. The representative provincial tax rate is assumed to be 55 percent — the rate that the Department of Finance uses

[4]The tax reform proposals also eliminate income averaging. This is clearly inappropriate given the rather draconian marginal rate hike as one passes the $27,500 threshold.

**Figure 2**

***Post-Reform Net Tax Gain for a Two-Adult Family with One Wage Earner***




Source: Marion Wrobel, "Tax Reform and Its Impact on Families," (Ottawa: Library of Parliament, 1987), p. 8.

in its own documents — and the 3 percent federal surtax is included.

Over the $27,500 to the mid-$40,000 income range, marginal rates would be ***higher*** under tax reform. The exact range over which these rates would be higher obviously depends on the level of deductions under the existing system. For example, under the existing system, if the two adults are over 65, they are also able to claim age exemptions totaling $5,340 — line 26 of the calculation sheet for the current system in the Appendix. Thus, in Figure 1, the marginal rate curve for the existing system would shift to the right by $5,340, so that the new marginal rates would be higher in the range of $27,500 to roughly $50,000. The range would extend even further if the income was in the form of dividends or capital gains since (i) the existing $1,000 deduction for interest and dividend income would be removed entirely from the new system and (ii) capital gains and dividends would be

treated less generously under the new system.

Not surprisingly, the tax reform package does not focus on this pattern of marginal rates. Rather, the *White Paper* directs most of its comparisons to *average* tax rates. In its various examples, average post-reform tax rates are shown to be lower across all income groups, as long as income is defined as wage income. To be sure, the percentage gains would behave in the manner suggested by Figure 1 — that is, they would rise up to $27,500, decline (but remain positive) until somewhere in the mid-$40,000 range, and then rise again.

Once one combines wage income with capital gains income or even self-employment income, the picture changes. This is hardly surprising, since one of the objectives of reform is to move in the direction of greater horizontal equity — that is, to subject capital gains and self-employment income to enhanced taxation. Figure 2 compares gains by income level when investment income is added to wage income according to the patterns derived from the national taxation statistics for 1984. (For example, for wage income in the $20,000 to $50,000 range, investment income runs between 6.9 percent and 9.6 percent of wage income.) Gains would be highest at the low-income end, negative in the middle-income range, and then positive again at the high-income end. The fact that the post-reform gains for families with children would be smaller than under the present system basically reflects the fact that tax reform would be more generous in converting deductions into credits for the breadwinner and spouse than for children.

In any event, the message here is clear: tax reform would not do much for the middle class. The underlying reason for this stems from the dramatic increase in tax rates at the $27,500 threshold — 9 federal percentage points and 14 combined federal-provincial points. Once again, however, while the government implicitly recognizes this feature of the first-stage reforms, it is not explicit in the tax reform documents. Enter the second-stage reforms.

## The Second-Stage Reforms and the Middle Class

With the revenues generated by the second stage of tax reform, the federal government proposes to accomplish four objectives:

- to replace the revenues now obtained from the existing manufacturers' sales tax;
- to remove the existing personal and corporate income surtaxes;
- to provide a significantly enriched refundable tax credit that would ensure a greater degree of tax fairness for low-income Canadians than currently

**Table 1**

***Revenue Implications of Various Tax Changes***

| Item | Revenues in 1988 dollars |
|---|---|
| Current manufacturers' sales tax (MST) | 15 billion |
| Multistage tax on consumption (excluding noncommercial activities such as medical services) at 8 percent | 2.9 billion per point<br>23.2 billion |
| Therefore, about 5.2 points will replace revenues from MST. | |
| **Tax change** | **Revenue cost (–) or gain (+), in 1988 dollars** |
| Reduce top bracket by 1 percent (e.g. from 29% to 28%) | -200 million |
| Reduce middle bracket by 1 percent (e.g. from 26% to 25%) | -500 million |
| Reduce lowest bracket by 1 percent (e.g. from 17% to 16%) | -2.6 billion |
| Reduce taxes across the board by 1 point | -3.3 billion |
| Eliminate dependency status for those 18 and over living at home | +100 million |
| Implement proposed tuition credit and transfer | -80 million |
| Eliminate surtaxes | -1.8 billion |
| Eliminate $1,000 investment income deduction | +950 million |
| Eliminate $500 employment expense deduction | +969 million |

Source: Department of Finance figures, as reflected in the government's tax reform documents or obtained from testimony of Department of Finance officials before the House of Commons Standing Committee on Finance and Economic Affairs, particularly Issue no. 71 (Monday, June 22, 1987), pp. 27, 37-40.

exists; and

- *to fund further income tax reductions for middle-income families.*[5]

Toward this end, Table 1 pulls together some figures that officials at the Department of Finance presented in their various appearances before the Blenkarn Committee. As noted in the second item in the table, the broadest possible multistage tax, exempting only noncommercial items such as medical insurance payments, would generate roughly $2.9 billion for each point of the multistage sales tax. For illustrative purposes, the Department

[5]Department of Finance, *Tax Reform 1987: Sales Tax Reform* (Ottawa, June 18, 1987), p. 29.

of Finance uses an 8 percent tax rate, which would generate revenues of $23.2 billion — $8.2 billion more than revenues generated under the current MST. On some other occasions the department assumes $3 billion per tax point for a total of $24 billion.

To judge from the evidence given before the Blenkarn Committee, the Department of Finance officials would appear to be comfortable with a refundable tax credit of $300–400 per year for a single person and $500–600 for a family and, presumably, with an increase in the current $35 per child. The revenue cost of this would be about $3 billion. Moreover, the department assumes that the credit likely would begin to be phased out at about $24,000 of income rather than at the current level of $16,000.[6]

Once these credits are deducted from the $8.2 billion of new sales tax revenues, this would leave $5.2 billion. Removing the existing 3 percent federal surtax on personal and corporate taxes — equal to $1.8 billion, as Table 1 indicates — would leave $3.4 billion.

$3.4 billion would allow for some very significant alterations in marginal rates. For example, the 17-26-29 structure of statutory federal rates could change to 17-22-27, with some income to spare. Table1 shows that the four-point drop in the middle bracket would cost $2 billion and the two-point drop in the top tax rate would cost $400 million, leaving more than $1 billion with which to reduce corporate rates in order to maintain the existing degree of integration between personal and corporate income taxes.[7]

In their testimony, the Department of Finance officials did not say what shape they thought any future rate structure might take, but, in response to questions, they did entertain the combined possibility of decreasing, in the second stage, the middle-income tax rate and increasing the ***threshold*** income level at which the middle rate would begin to apply.

All of this suggests a series of pertinent observations:

- Why did the department propose a 17-26-29 tax rate system in the first place? The move from 17 percent to 26 percent combined with, say,

[6]It is not at all evident why one would want to raise the threshold for clawing back the refundable sales tax credit. If the goal is to help low-income families, then why not keep the claw-back threshold at $16,000 and have a correspondingly higher credit? Or, why not keep the level of the credit the same (as proposed in the second stage), keep the claw-back threshold the same, and provide help to middle-income families by reducing marginal rates? This relates to a general problem with tax reform exercises in Canada. The government is responding to Canadians' desire to see benefits become better targeted. In the process, however, these attempts at targeting are themselves not sufficiently selective or targeted (see Thomas J. Courchene, *Social Policy in the 1990s: Agenda for Reform*, Policy Study no. 3 [Toronto: C.D. Howe Institute, 1987], chapter 11).

[7]Alternatively, this excess sales tax revenue could be used to generate the "flat but progressive" single rate referred to earlier.

Ontario's 50 percent rate actually would increase marginal rates from 25.5 percent to 39 percent, an enormous hike for incomes as low as $27,500. And they would rise to 44 percent with the 5 percent child tax credit clawback in place.

- The implications of undertaking tax reform in two stages are really quite remarkable: a full-blown national debate about marginal rates and thresholds in the fall of 1987, to be followed by *another* full-blown debate on marginal rates and thresholds when the second stage is implemented. Canadians have not been able to undertake even *one* major rethink of the system since Carter. How can we do *two* in one year?
- Since the advent of tax reform in the United States, the pressing need in Canada has been to reform the *corporate* side, not the personal side.[8] One year would not make much of a difference for the personal income tax.
- Finally, and most importantly, the greatest negative impact on Canada's competitive position comes from the existing sales tax. As noted earlier, roughly $2 billion of the $15 billion in sales taxes is built into the cost of Canadian exports, thereby placing a substantial burden on exporters. Add to this the fact that the MST does not fully catch manufactured imports. We cannot afford to risk this aspect of tax reform. Yet, implementing the reform in two stages may do precisely this.

The Department of Finance must be rationalizing its approach along the following lines. The lowering of marginal rates and the conversion of exemptions to credits is enough to "sell" the first stage. The second stage becomes desirable — and "sellable" — because it would get rid of surtaxes, reduce taxes for the middle class, and offer generous tax credits for the low-income groups. And, of course, it would help competitiveness because of the way it treats both exports and imports. As many people have pointed out, however, the complication is that the second stage would coincide with the run-up to the next federal election and could give way to electoral politics.

The concern is not just that the second stage may not materialize; it is also that the first stage, by itself, may not be fiscally stable. Setting aside the implications of the currently rising interest rates on debt servicing, it is likely that some of the first-stage reform proposals — such as the dropping of credits for 18-year-olds living at home, the substantial burden placed on the insurance sector, and the treatment of investment income — will run

[8] If corporate rates are higher in Canada, multinational enterprises would have an incentive to "transfer" deductions, such as interest costs, to Canada and profits to the United States.

into tough sailing. Unless such changes are accommodated by enhanced revenues elsewhere, the end result of the first stage would be larger deficits or higher marginal rates or both.

If the government is intent on implementing the reform process in two stages, it would seem to be preferable to have a first stage that focused on corporate tax reform and perhaps some of the proposed alterations in the MST. Then the second stage could include all the rest — the personal income tax, a multistage sales tax, and, perhaps, some further reform of the corporate tax. The point is simply that the reform of the personal income tax is incomplete without the second stage. Phrased somewhat differently, it is difficult for middle-income Canadians to become excited about the first stage of tax reform on the basis that they will be rewarded in the second stage. This comment is not based simply on the pre- and post-reform comparisons shown in Figure 2. With combined federal-provincial marginal rates of 40 percent at an income threshold as low as $27,500, young, mobile, highly skilled college graduates would have considerable incentive to move south. It may well be that the first-stage reforms, designed as they are to take effect in the new year, are cast in stone. But this only intensifies the federal government's need to ensure that the second stage materializes.

## The Implications for Social Policy

In the February 1986 budget, the federal government promised a full review and reform of social policy as an integral part of its 1987 budget. That this did not materialize is unfortunate, since social programs and the tax system are highly interrelated. Tax reform provides an ideal window of opportunity to undertake social policy reform.

Many well-documented problems with the social policy network are essentially "tax" problems. A list of such problems would include the fact that the "aggregate" tax rate — that is, taxes plus lost benefits such as housing allowances, free drugs, and so on — in the transition from welfare to work typically exceeds 100 percent, thereby creating poverty traps; and the fact that unemployment insurance (UI) increasingly is becoming an income supplementation program rather than an income replacement program and, as such, this component of UI ought to be replaced by a tax-transfer system.

Some of these social programs probably are amenable to unilateral reform, but others probably are not. For example, it is much harder to contemplate substantial UI reform in isolation than it is in the context of a

broader reform that includes appropriate changes in other subsystem components — such as the family benefits package of the personal income tax — to accommodate any negative spillovers and to magnify potential incentive and efficiency gains. Suffice it to say that one window of opportunity for social policy reform is now closed. More importantly, many of the "sweeteners" that will be needed to "buy" meaningful social policy reform have now been bartered away.

Nonetheless, some features of tax reform have important implications for social policy evolution. The most obvious of these is the move from exemptions or deductions to credits. Most versions of negative income taxation, or of guaranteed annual income, embody the concept of *refundable* tax credits with claw-backs. Since the first-stage reforms would convert virtually all of the basic exemptions to credits, this would prepare the way for making them refundable and income tested in the context of some version of a guaranteed annual income. Indeed, for some time now, Canada has accepted the concept of refundable child tax credits. Assuming the second-stage proposals materialize, Canada for the first time would introduce sizable *adult* refundable tax credits; again, this would be a major step toward a guaranteed annual income. The conversion of exemptions to credits would also provide an incentive for labor force participation by spouses since, under the credit system, the additional earned income would not be taxed at the higher marginal rate of the family's prime income earner.

Some aspects of the reform would enhance the targeting of benefits. Under the existing system, family allowances are taxable, but the child exemption has been generally sufficient to offset the tax cost of including family allowances in income. Under tax reform, the child exemption would be converted to a credit at the 17 percent rate. For those in the 26 percent or 29 percent tax brackets, this would imply a fairly significant erosion of benefits. (There is, however, an obvious incentive for the lower-income earner in a two-income family to take both the family allowance income and the credit, especially if he or she is in the 17 percent bracket.)

On the other side of the ledger, some of the reform proposals appear to have negative social policy implications. Removing the child credit for 18-year-olds still living at home clearly is a case in point. If the 18-year-old is an only child in a single-parent family, the loss is *significantly* greater, since the "equivalent to spouse" credit is also lost. Moreover, the proposal to allow students attending universities and colleges to transfer to their parents up to $600 of their tuition tax credits certainly adds to the perception of

inequity. It may well be that transferable tax credits for postsecondary education are appropriate, but viewed as a package with the treatment of, say, unemployed 18-year-olds living at home, the overall proposals take on an elitist bent.

### *Tax Reform and the Elderly*

Consider the situation of a family of two as they reach age 65. At this point, the new tax transfer system would affect them in two ways. First, both would receive old age security (OAS) payments of $3,740, for a total of $7,480. Second, both would qualify for the transferable age credit of $550 as well as the pension credit of $170. If my calculations are correct, they would have to have a total income (including OAS) of $41,500 before having to pay any *net* positive personal income tax — that is, the income tax payable at $41,500 would equal $7,480, which would offset exactly the value of their OAS payments. Put somewhat differently, if the family's outside wage and/or pension income totaled $34,020 — $41,500 less $7,480 — its after-tax income also would be $34,020. By way of contrast, the same family at age 64 would pay net income taxes of $7,250 if the breadwinner earned $34,020.

Since OAS payments come out of federal coffers, the appropriate break-even income level might be where *federal* taxes payable equal $7,480. This income level is $51,000. It would be even higher if the income is split between the couple so that both remain in the 17 percent tax bracket and/or if some or all the income comes from capital gains or dividends, rather than from wages or pensions as the above calculations assumed.

Before focusing on the implications of these changes, it is important to recognize that the break-even levels are of roughly the same magnitude under the existing tax regime. Tax reform would benefit the lower-income elderly, but this is offset by the fact that, under the new system, marginal rates would be higher between the $27,500 threshold and the above break-even levels. Indeed, because of the way it treats dividend and capital gains income, the new system actually would reduce the break-even levels for pensioners receiving income in this form.

Nonetheless, I think one can make a case that the new system would treat the elderly rich far too generously. A more targeted approach would generate substantial tax savings, some of which could be allocated, for example, to more generous payments to the elderly poor, to restoring fiscal integrity, or to reducing marginal rates.

One can put the issue in a broader context. First, because of the

demographic profile and increased life expectancy, the number of elderly is increasing rather dramatically. Second, and more importantly, as a group, the next generation of elderly will be far more affluent than either the last or the current generation. Many more Canadians now have substantial pensions. Moreover, the higher-income groups typically have availed themselves of Registered Retirement Savings Plans and other tax-assisted savings vehicles. Despite this, even for the high-income elderly — those in the 29 percent bracket — the tax break remains in the neighborhood of $7,000 once an elderly couple crosses the 65-year threshold.

As noted above, the reform proposals would target benefits somewhat better by converting the current age and pension exemptions into credits at the 17 percent rate — rather than the top marginal rate of 29 percent — and by improving the tax treatment of nonwage income. But the reform package does not even explore bolder targeting moves, such as gradually making the age exemption a refundable tax credit — effectively folding it into the Guaranteed Income Supplement for the elderly — or simply taxing it away beyond some income threshold.

One can argue that Canada is probably a decade away from a substantial increase in both the number and the proportion of elderly rich. But it is also the case that changes such as those outlined above are difficult to sell politically. By not implementing them (gradually), given a tax reform package that generally appears to benefit the rich (by lowering top marginal rates), there is a substantial likelihood that they will never be implemented. To be sure, this is a criticism of what the package does not include, as distinct from what it does include, but the concern nonetheless merits highlight.

## The Treatment of Investment Income[9]

It is instructive to compare the manner in which the Canadian and U.S. tax reform initiatives have approached the treatment of corporate-derived income — that is, the manner in which they integrate the personal and corporate income tax systems.

On the U.S. side, the answer is simple. There is no integration: the United States has *full double taxation* of corporate-derived income. There is no dividend tax credit, and capital gains are now subject to full taxation.

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[9]Much of the analysis in this section is adopted from Donald R. Huggett, "Tax Reform: Equity Capital," *Canadian Tax News* 15 (July-August 1987): 31-49. I also benefited from discussions with Tom Wilson.

Indeed, the United States introduced a new wrinkle: the top marginal personal tax rate in some states is now below the corporate rate. Hence, if one's goal is to accumulate capital, then being unincorporated could now be preferable to being incorporated. In this sense, then, the U.S. system creates significant incentives for disincorporation, the effects of which have not yet fully surfaced. The betting is that this situation is not sustainable and that modifications are forthcoming.

In sharp contrast to the U.S. changes, the Canadian reform proposals, perhaps influenced by Carter, attempt to integrate personal and corporate taxation. The principal vehicle here is the dividend tax credit, and the reason the Canadian reforms do not follow those of the United States in making capital gains fully taxable is this concern about integration and double taxation. But, as tax specialist Donald Huggett of Coopers & Lybrand has pointed out, the United States traded off a 13 percent increase (from 22 percent to 35 percent) in combined federal and state marginal tax rates on capital gains in return for a 20 percent decrease (from 55 percent to 35 percent) in marginal rates on all other sources of income. In Canada — setting aside the capping of the $500,000 exemption at $100,000 — the change at the top marginal rate would be a 6.25 percent increase in capital gains for a reduction in overall rates of 9.2 percent.[10] However, the middle-income elderly — defined for present purposes as those falling in the income range of $27,000 to roughly $50,000 — not only would have 75 percent of their capital gains taxed as income (compared with 50 percent now), ***but their post-reform marginal rates also would be higher!*** In spite of this, the Canadian approach is to be preferred on *conceptual* grounds. This is the first point.

The second point is that, given Canadians' belief in integration and the equivalent treatment of capital gains and dividend income, we should get it right. Tax reform falls way short here. I shall deal first with the dividend tax credit.

### *The Dividend Tax Credit*

Until 1987, dividends were subject to a gross-up of 50 percent and to a tax credit of 35 percent of the grossed-up amount. This integrated the personal and corporate tax systems for high marginal rate taxpayers at a corporate rate of roughly 33$^1/_3$ percent. As Huggett points out, this admittedly was a compromise since corporate tax rates in the early 1970s, when the credit

[10]Ibid., p. 34.

was introduced, ranged from 25 percent for small businesses to over 50 percent for large corporations.[11] The 1987 budget then reduced the degree of integration to the corporate rate of 25 percent. The reform proposals would reduce this still further, to 20 percent. Specifically, dividends would be grossed up by 25 percent, and a tax credit of 20 percent — 13⅓ percent federal and 6⅔ percent provincial — of the grossed-up amount would be allowed. The government argues that, with tax reform, the *average* corporate tax rate would be 20 percent. Huggett points out two problems with this approach, however. First, this is the average *federal* rate, and integration should occur at the 25 percent level or higher if one takes into account provincial corporate tax rates, particularly since the credit itself is on a two-thirds/one-third basis between Ottawa and the provinces. Second, if one takes into account the effective tax rate on corporations that *actually or typically pay dividends*, then the pre-1987, 33⅓ percent integration level remains the appropriate one.[12] From this perspective, the tax reform proposals fall far short of achieving the desired integration of the personal and corporate tax systems.

One final comment is appropriate. It is admittedly difficult to integrate the two systems when *both* have multiple rates. As noted earlier, Canada is within striking distance of achieving a "progressive" flat marginal rate. The preferential small business rates also complicate the integration process. I fully endorse Huggett's comment that:

> Undoubtedly some concessions may be appropriate for small business, but to offer all of them special tax rates equal to 43% of the general rates seems a bit much, and all the more so if this low rate is used as an excuse to lower the integration formula for all corporations.[13]

I would go further. Each of the three principles that appear to underlie tax reform would be enhanced if the overall corporate rate were lowered, if the differential rates for small business were eliminated, and if, in the process, the remaining rates were reduced in a revenue-neutral way.

### *Capital Gains Taxation*[14]

Capital gains taxation has been the wild card in terms of investment

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[11]Ibid., p. 35.

[12]Ibid.

[13]Ibid., p. 36.

[14]The analysis in this section relates to corporate-linked capital gains. It seems to me that capital gains arising from speculating on currencies, for example, should be treated as any other income.

income. During much of the postwar era, capital gains have been preferred to dividend income, and the tax system has had to find ways to reduce the incentive for diverting dividend income to capital gains income. By the early 1980s, the equivalence of these two types of income finally had been achieved. Then, the Mulroney government reintroduced the bias in favor of capital gains with a $500,000 lifetime exemption for such income. Not surprisingly, with this provision has come a further surge of activity toward converting dividends to capital gains and a series of countermeasures by the government designed to thwart these initiatives. The tax reform proposals reverse this bias. Dividends would be treated preferentially relative to capital gains even though the approach to dividend taxation itself is inappropriate, as elaborated previously.

In principle, I am in favor of reducing the exemption to $100,000; more correctly, I viewed the initial $500,000 exemption as a backward step in the evolution of the tax system. The reforms, however, would go further: 66⅔ percent of capital gains would be required to be taken into income in 1988 and 1989, and this rate would rise to 75 percent in 1990 and beyond. As Huggett demonstrates, this would reverse the traditional bias in favor of capital gains: incentives would exist to ensure that income rises in the form of dividends rather than capital gains.[15] Moreover, this neglects the important fact that capital gains would not be adjusted for inflation, as they should, for tax purposes.

In my view, the appropriate approach is to provide full integration of dividend income at the typical federal-provincial tax rates and to ensure that *after-inflation* capital gains are taxed on a similar basis. The argument that 75 percent is midway between the existing 50 percent rate and the 100 percent rate that applies in the United States may be politically salable, but it is conceptually empty. The idea should be to maintain a semblance of neutrality between dividends and capital gains. If the dividend tax credit is integrated at a 25 percent corporate rate — the existing 1987 provision — then a 60 percent inclusion rate for capital gains is acceptable. If integration were to occur at a 20 percent corporate tax rate as proposed, then neutrality suggests that the inclusion rate for bringing capital gains into income should not exceed 50 percent.[16] Table 2 presents the backdrop for this conclusion.

In this context, it is appropriate to focus on the "anti-avoidance" legislation that is part of the reform proposals. The aim of this legislation is

[15]Huggett, pp. 43-45.
[16]Ibid., p. 44.

## Table 2

### *Net After-Tax Return on Dividend and Capital Gains*

*(dollars)*

| | Tax bracket | | | | | |
|---|---|---|---|---|---|---|
| | 25.5% | | 39% | | 43.5% | |
| | Integration | | Integration | | Integration | |
| | 25% | 20% | 25% | 20% | 25% | 20% |
| *Dividends* | | | | | | |
| Actual dividend | 600 | 600 | 600 | 600 | 600 | 600 |
| Gross-up | 200 | 150 | 200 | 150 | 200 | 150 |
| | 800 | 750 | 800 | 750 | 800 | 750 |
| Tax | 204 | 191 | 312 | 292 | 348 | 326 |
| Dividend credit | 200 | 150 | 200 | 150 | 200 | 150 |
| | 4 | 41 | 112 | 142 | 148 | 176 |
| Net to shareholder | *596* | *559* | *488* | *458* | *452* | *424* |
| *Capital gains* | | | | | | |
| Capital gain | 600 | 600 | 600 | 600 | 600 | 600 |
| Excluded amount: 1/4 | 150 | 150 | 150 | 150 | 150 | 150 |
| | 450 | 450 | 450 | 450 | 450 | 450 |
| Tax | 115 | 115 | 175 | 175 | 196 | 196 |
| Net to recipient | *485* | *485* | *425* | *425* | *404* | *404* |
| Capital gain | 600 | 600 | 600 | 600 | 600 | 600 |
| Excluded amount: 1/3 | 200 | 200 | 200 | 200 | 200 | 200 |
| | 400 | 400 | 400 | 400 | 400 | 400 |
| Tax | 102 | 102 | 156 | 156 | 174 | 174 |
| Net to recipient | *498* | *498* | *444* | *444* | *426* | *426* |
| Capital gain | 600 | 600 | 600 | 600 | 600 | 600 |
| Excluded amount: 1/2 | 300 | 300 | 300 | 300 | 300 | 300 |
| | 300 | 300 | 300 | 300 | 300 | 300 |
| Tax | 77 | 77 | 117 | 117 | 131 | 131 |
| Net to recipient | *523* | *523* | *483* | *483* | *469* | *469* |
| Capital gain | 600 | 600 | 600 | 600 | 600 | 600 |
| Excluded amount: 40% | 240 | 240 | 240 | 240 | 240 | 240 |
| | 360 | 360 | 360 | 360 | 360 | 360 |
| Tax | 92 | 92 | 140 | 140 | 157 | 157 |
| Net to recipient | *508* | *508* | *460* | *460* | *443* | *443* |

Source: Donald R. Huggett, "Tax Reform: Equity Capital," *Canadian Tax News* 15 (July-August 1987): 44.

to "prevent artificial tax avoidance transactions or arrangements but at the same time is not intended to interfere with legitimate commercial and family transactions."[17] If this provision remains intact, it would introduce a degree of uncertainty in tax planning hitherto unknown in this country. Its intention to "seek to distinguish between legitimate tax planning and artificial tax avoidance"[18] is inappropriate if it prevents citizens from converting income to sources that the government *itself* has favored under tax reform. As noted above, in an environment where the dividend tax credit integrates the personal and corporate tax systems at a 20 percent corporate rate, including 75 percent of capital gains in income embodies a clear incentive for individuals to seek dividend income. Should they attempt to do so, however, they likely would run up against the sweeping anti-avoidance procedures. It is difficult to believe that the government is intent on legislating such a provision, particularly since it is the reform proposals themselves that would generate the discrepancy in tax treatment. Why not simply remove the discrepancy?

More generally, the reform proposals would hit investment income tremendously hard, in the following ways:

- the $1,000 interest and dividend income deduction would be eliminated;
- the capital gains exemption would be capped at $100,000, rather than rising to $500,000 as originally announced;
- the amount of capital gains (in excess of the exemption) that must be brought into income would increase from 50 percent to 75 percent;
- there would be no inflation deduction for capital income, which could easily imply *negative real returns* on capital gains; and
- the dividend tax credit would be reduced to generate an integration of the personal and corporate tax systems at a 20 percent corporate rate when, in reality, a 33 percent rate would represent full integration more appropriately.

If this were not enough, on the corporate side the proposals would remove the investment tax credits, reduce the capital consumption allowances, and delay the date at which these allowances could begin to be claimed.

While some of these provisions are desirable in their own right, in total they would amount to a substantial attack against Canadians who invest. It is hard to believe that these reform proposals emanate from the same

[17]Department of Finance, *Tax Reform 1987: Income Tax Reform* (Ottawa, June 18, 1987), p. 137.

[18]Ibid.

government that argued so strenuously that the $500,000 capital gains exemption was essential to Canada's competitive future. My view of this dramatic turnaround is that it is related to — that is, constrained by — the two-stage tax reform process. In order to make the first stage revenue neutral, revenues have to come from somewhere. On the personal income tax side, they would come from increasing the tax rates on investment income. This is but another example of one of the general themes underlying this analysis — by seeking to make the necessary tradeoffs within *each stage*, the end result of the proposed tax reforms likely would be a quite different system than that which would have arisen had the reforms been undertaken in one uninterrupted stage. After waiting so long for tax reform, it is disconcerting, to say the least, that the *process* is driving the outcome.

To conclude this section, I shall focus on the elimination of the $1,000 investment income deduction. One can readily see the advantages of eliminating this tax break, particularly in light of what what said in the previous paragraph, since it nets the federal government roughly $1 billion per year. However, it was an obvious candidate for conversion from a deduction to a credit. For example, although taxpayers over age 65 accounted for only 8.2 percent of total income assessed in 1984, they were responsible for 25 percent of the total investment income deductions.[19] Hence, converting the $1,000 exemption to a $170 tax credit probably would be a progressive tax measure. Assuming, however, that such a recommendation would not be well received (on revenue grounds), I have a fallback recommendation. At the minimum, introduce, say, a $35 tax credit for investment income, which, at 17 percent, would cover investment income of just over $200.

The reason for this recommendation relates entirely to compliance costs. It is difficult to keep track of sources of income such as bank interest and small dividends, largely because the institutions that issue them tend not to report them on information slips. A $200 umbrella would save most taxpayers the problem of gathering these receipts. Failure to enact such a provision probably would not mean much in terms of extra revenues, since most low-income and even many middle-income taxpayers customarily ignore these small sources of income — as they do the $1,000 deduction — and probably would continue to do so. The important difference, however, is that when they sign their tax forms, they will know that they have not come clean with Her Majesty. It is mischievous, to say the least, for the

[19]Basil Zafiriou, "The Investment Income Deduction: Reform Proposals," (Research Branch, Library of Parliament, Ottawa, 1987).

government to put so much pressure on taxpayers when the revenue involved is trivial. Clearly, the point at issue is some ***de minimus*** credit. My suggestion of a $35 credit may be too generous; a $17 credit, covering $100 of such income, might even address the needs of low-income taxpayers.

Setting aside this latter point, the main conclusion of this section is that the federal government needs to rethink the ensemble of provisions relating to the taxation of investment income.

### Tax Reform and the Provinces

The impact of tax reform on the fiscal positions of the provinces is dealt with in Ted Carmichael's paper in this volume. It might be useful, however, to emphasize again the quite different position in which Quebecers find themselves with respect to federal tax reform.

Because of the federal tax abatement for Quebec's social programs, Quebecers pay less federal tax than do other Canadians — and the cash transfers from the federal government to Quebec are reduced accordingly. For Quebecers to receive the same benefits from federal tax reform as other Canadians, Quebec would have to generate personal income tax cuts equal to 80 percent of the federal cuts. This is a tall order for a province that already suffers from a strained fiscal position. Suppose Quebec argues that it wants to provide similar benefits to its citizens, but that the implementation timetable for the first stage is too short for it to rework its personal income tax system. This could effectively block quick implementation of the first stage, unless the federal government were simply to ignore Quebec's concerns. Viewed from a different perspective, this eventuality could slow down the process sufficiently to attempt to combine the two stages into one, as argued for earlier.

The main purpose of this last substantive section, however, is to focus on some aspects of the interaction between the federal and provincial personal tax systems.

Following the lead of Quebec's *White Paper on the Tax and Transfer Systems*,[20] several provinces are now in the process of examining their welfare systems in order to ensure that, among other things, consistent with their perceptions of equity, the income support options contained in the tax reform proposals encourage labor force participation.

As is well known, many existing provincial systems embody dollar-for-

[20]Québec, Ministre des Finances, *White Paper on the Personal Tax and Transfer Systems* (Québec, 1984).

dollar reductions in welfare for any earned income — that is, confiscatory tax rates. Among the new initiatives designed to remedy this situation is Quebec's recent budget provision of an "earned income supplement" that kicks in at an earning level of about $5,000 per year. Any earnings between $5,000 and the level at which payments normally would cease are supplemented by 35 percent — that is, the overall tax rate is reduced from 100 percent to 65 percent. After the welfare payments cease, this supplement is taxed back at, say, a 65 percent rate, for a break-even level in the neighborhood of $15,000 (varying with family status). Thus, the typical dollar-for-dollar reduction of welfare payments continues to exist up to $5,000 of earned income. Thereafter, until several thousand dollars beyond the old welfare limit, the rate at which benefits are reduced effectively becomes 65 percent — not an enviable rate but certainly a great improvement over one that is confiscatory. Quebec is using its personal income tax system to reconcile all of this on an annual basis.

The other provinces do not have as much freedom because they are tied into the federal rate and bracket structure. Presumably, the federal government continues to stand ready to allow and to administer provincial tax credits and surcharges. These credits are likely to mushroom in the future, however, as provincial welfare systems increasingly use the tax system as the delivery mechanism for — or, at least, the "reconciler" of — novel income support policies.

In this context, an obvious question arises. Why does the federal government force its rate and bracket structure on the provinces by requiring that they apply a *single* rate to federal basic tax? Under the first-stage proposals, for example, the federal 17-26-29 rate progression would become 24.9-38.1-42.5 for Albertans (with a 46.5 percent tax rate) and 27.2-41.6-46.4 for Newfoundlanders (with a 60 percent tax rate). What logic requires Newfoundland, if it wishes to tax its citizens more than Alberta does, to be constrained by the way the federal government sets its tax parameters? This is particularly the case given the manner in which the first-stage reforms treat middle-income taxpayers. Moreover, the federal government *does* allow the provinces to apply their *own* marginal rates to the corporate tax base. Why not for the personal tax base as well?

In 1983, an Ontario Economic Council study[21] of whether or not Ontario should adopt its own personal income tax recommended that the provincial "tax on tax" be converted to a "tax on base" to allow the provinces

[21] Ontario Economic Council, *A Separate Personal Income Tax for Ontario* (Toronto, 1983).

greater flexibility in determining the income distribution consequences of the personal income tax for their own citizens. Actually, this approach is much more easily accommodated under the existing deduction concept than it would be under the new credit concept. For an idea of what such a process would entail, see the tax calculation sheet for the new system in the Appendix, which reproduces the steps through which a taxpayer would have to go to prepare his or her "new" income tax form. To allow the provinces the freedom to determine tax rates and brackets — but *not* the definition of what constitutes income or the basic relationship among the various tax credits — line 48 would be replaced by the following:

A. Tax on taxable income (apply attached provincial rate and bracket schedule to line 23);
B. Tax credits (for example, for Alberta, 46.5% of line 40);
C. Equals provincial tax payable (before any provincial surtaxes and credits).

This approach would allow the provinces to have some impact on the distributional consequences of the tax system without their being able to influence what constitutes income. In other words, it would act as a kind of halfway house between the current system and allowing the provinces their own personal income tax systems. Should Saskatchewan prefer a relatively flat tax, as it has indicated recently that it does, it would be free to have only one marginal tax rate, and so on. To be sure, this would decentralize the tax system somewhat, but only to the degree allowed under the corporate tax arrangements. I readily admit that this recommendation reflects my bias in favor of decentralization. However, it is a whole lot better than having Ontario, or other provinces, withdrawing from the tax arrangements and establishing their own personal tax systems simply because they find some aspect of the federal rate and bracket structure unacceptable.

It is clearly in the national interest to attempt to keep the present tax collection agreements in place. This probably would require that the federal government stand ready to collect a rather broader range of provincial credits and surcharges in the future. If these surtaxes or credits are sufficiently broad, however, then there really would be no difference between a comprehensive provincial surtax-credit system on the one hand and allowing the provinces the freedom to set their own rate and bracket structures on the other. The advantage of the latter would be greater to the extent that the provinces begin to utilize the personal tax system as the backbone of their income support policies.

## Conclusion

The federal government has approached tax reform from the vantage point of a series of generally accepted principles, including:

- broadening the tax base;
- lowering marginal rates;
- increasing the degree to which incomes from alternative sources are treated equally;
- addressing concerns about progressivity, as reflected in the conversion of exemptions to credits and in the introduction of further low-income refundable credits;
- maintaining some degree of integration between the personal and corporate tax systems;
- addressing concerns about Canada's competitiveness, as reflected in the proposals to replace the manufacturers' sales tax with a multistage sales tax; and
- devoting a much greater concern about the transition problems than was evident in the 1981 attempt at reform.

Canadians find all or most of these characteristics appealing. In addition, the proposals were crafted in such a manner as to ensure that most comparisons between the current and new personal income tax systems favor the new.

The attempt to achieve all of these goals simultaneously, however, is not without significant costs. Deficit reduction has gone by the wayside, as has thorough social policy reform. And the multistage sales tax may well be less likely now than it was prior to the reform. Politically, the tax reform architects no doubt were required to focus some attention on pre- and post-reform comparisons. At best, however, close attention to such old-new comparisons restricts the design flexibility of the new system and, at worst, tends to lock the new system into any peculiar, and sometimes inappropriate, features of the existing system.

In general, these multiple goals probably have loaded the dice in favor of tax reform critics, who are free to evaluate the new system either on its own merits or in terms of old-new comparisons. Frequently, measures that make eminent sense as part of a new approach to taxation come up short in such comparisons. Indeed, I suspect that, on occasion, the analysis presented here has also shifted between these two benchmarks, even though the intention was to focus primarily on the features of the new system. In this context, I should note that the principal concern about the manner in

which middle-income Canadians would be taxed in the first stage does not arise from old-new comparisons but from the view that subjecting incomes as low as $27,500 to marginal rates in the mid-40s is conducive neither to efficiency nor to retaining Canada's human capital.

My overall conclusion is that a meaningful reform package must incorporate the second stage. I sincerely hope that the Minister of Finance has read the politics right, in the sense that the four-pronged approach to the second stage — removing surtaxes, introducing substantial low-income tax credits, replacing the MST by a multistage sales tax, and implementing tax relief for the middle class — is sufficiently appealing that the entire tax reform package will be legislated.

Even if the entire package is legislated, however, some concerns will persist, since tax reform has avoided the challenge of tackling overall fiscal and social policy reform. With post-reform access to a comprehensive tax base — in terms of both income and sales taxation — the government of the day may well be tempted to ratchet up tax rates rather than to embark on tough decisions on the fiscal and social policy fronts.

One can applaud the present federal government for having embarked on tax reform and for its selection of underlying goals. But my guess is that future tax reformers are likely to look back on the current attempt with something less than enthusiasm. In view of what has been bartered away in the first stage of the reform process, the government has missed a golden opportunity to make more of the tough but essential decisions that are required on the tax, fiscal, and social policy fronts.

# Appendix

## *Calculating Personal Income Tax: An Illustrative Guide*

### *Introduction*

The attached calculation sheets are intended to help in estimating how personal income tax will change as a result of tax reform. They are for illustrative purposes only — they are not sample tax returns. A number of specific measures that apply to relatively few taxpayers are not included in this guide.

To permit comparative calculations based on the 1988 tax year, estimates are provided for a number of payments, exemptions and deductions for that year. These are shown on the appropriate lines of the comparative calculation sheets or indicated in the notes below.

The basic steps in calculating tax remain the same before and after tax reform. The major difference is that a number of exemptions and deductions will be converted to tax credits. As a result, they will be deducted directly from tax in the final calculation stage under the new system.

The 1986 general tax guide provides detailed explanations of existing tax provisions. For detailed explanations of the changes in the new system, please consult the White Paper and the background paper, Income Tax Reform. The background paper contains an illustrative calculation using a specific taxpayer example on pages 29–30. You may wish to read it before using the calculation sheets.

The following information will help in using the calculation sheets:

### *Sources of Income*

*CPP/QPP* [Canada Pension Plan/Quebec Pension Plan]: Current recipients can estimate 1988 value of benefits by multiplying 1986 benefits by 1.12.
*Dividends*: Taxable amount of dividends is 133 percent of cash dividends in existing system, 125 percent in new system.
*Taxable capital gains*: One-half of total capital gains in existing system and two-thirds of total in new system.

### *Deductions*

*CPP/QPP deduction* in existing system is 2 percent of earnings in excess of $2,700, up to maximum earnings of $27,500.
*UIC* [*Unemployment Insurance Commission*] *deduction* in existing system is 2.35 percent of employment income up to $29,380.
*Lifetime capital gains deduction*: see pages 78–81 of Income Tax Reform for explanation of changes in treatment of the capital gains deduction.

### *Tax Credits*

Credits in new system are as follows:

***Pension income credit***, 17 percent of pension income to a maximum credit of $170.
***Transferable amount of age, pension and disability*** credits is equal to total credits minus 17 percent of tranferor's net income in excess of $6,000.
***Tuition*** deduction is converted to credit under at 17 percent of deduction.
***Education*** credit is $10 per month for each month in school; unused portion of the first $600 of combined tuition and education credit can be transferred to a supporting person.
***CPP/QPP and UIC*** credits are 17 percent of contributions.
***Allowable medical expenses*** exceeding 3 percent of net income are converted to credit at 17 percent.
***Charitable credit*** is 17 percent of first $250 in donations plus 29 percent of additional donations
***Dividend tax credit*** in existing system is $16^{2}/_{3}$ percent of taxable dividends and in new system $13^{1}/_{3}$ percent.

### *Calculating Federal Tax on Taxable Income*

Current System:

| *Taxable Income* | *Tax* | | |
|---|---|---|---|
| $ 1,134 or less | | 6% | |
| 1,334 | $ 80 | + 16% on next | $ 1,334 |
| 2,668 | 293 | + 17% on next | 2,668 |
| 5,336 | 747 | + 18% on next | 2,668 |
| 8,004 | 1,227 | + 19% on next | 5,336 |
| 13,340 | 2,241 | + 20% on next | 5,336 |
| 18,676 | 3,308 | + 23% on next | 5,336 |
| 24,012 | 4,535 | + 25% on next | 13,340 |
| 37,352 | 7,870 | + 30% on next | 26,680 |
| 64,032 | 15,874 | + 34% on remainder | |

New System:

| *Taxable Income* | *Tax* | | |
|---|---|---|---|
| $27,500 or less | | 17% | |
| 27,500 | $ 4,675 | + 26% on next | $27,500 |
| 55,000 | 11,825 | + 29% on remainder | |

### *Federal Tax Calculation*

*Surtax* is 3 percent of basic federal tax.

*Refundable child tax credit* of $524 per child is reduced by 5 percent of net income (of both spouses) in excess of $24,020.

*Refundable sales tax credit* in the existing system of $50 per adult and $25 per child under 18 is reduced by 5 percent of net income in excess of $15,000 in existing system. New system: credit is increased to $70 per adult and $35 per child under 18 and is reduced by 5 percent of net income in excess of $16,000.

### *Calculating Provincial Tax*

Every province and territory (with the exception of Quebec, which has its own income tax) collects its income tax at the same time that federal income tax is collected.

Provincial taxes can be obtained by multiplying federal basic tax by the provincial tax rate for the province of their residence.

*Tax Rates for Provinces and Territories*
(As a percentage of basic federal tax)

| | |
|---|---|
| Newfoundland | 60.0% |
| Prince Edward Island | 55.0% |
| Nova Scotia | 56.5% |
| New Brunswick | 58.0% |
| Quebec | — |
| Ontario | 50.0% |
| Manitoba | 54.0% |
| Saskatchewan | 50.0% |
| Alberta | 46.5% |
| British Columbia | 51.5% |
| Northwest Territories | 43.0% |
| Yukon | 45.0% |

This form cannot be used by residents of the province of Quebec to calculate provincial tax. Federal tax calculation allows residents of Quebec an abatement of 16.5 percent of federal basic tax.

Calculation sheet follows.

## *Illustrative Individual Income Tax Calculation Sheet: Existing System*

*Sources of Income*

| | | |
|---|---|---|
| 1. | Net employment income | ..... |
| 2. | Old age security pension ($3,740) | ..... |
| 3. | Canada/Quebec pension plan benefits | ..... |
| 4. | Other pension income | ..... |
| 5. | Family allowance payments ($388 per child) | ..... |
| 6. | Taxable amount of dividends | ..... |
| 7. | Interest income | ..... |
| 8. | Net rental income | ..... |
| 9. | Taxable capital gains | ..... |
| 10. | Net self-employment income | ..... |
| 11. | Other income | ..... |
| 12. | *Total income* (add lines 1 to 11 inclusive) | ..... |

*Deductions*

| | | |
|---|---|---|
| 13. | Employment expense deduction (max. $500) | ..... |
| 14. | Canada/Quebec pension plan contributions (max. $496) | ..... |
| 15. | Additional contributions by self-employed (max. $496) | ..... |
| 16. | Unemployment insurance premiums (max. $690) | ..... |
| 17. | RPP & RRSP contributions | ..... |
| 18. | Union & professional dues | ..... |
| 19. | Tuition fees | ..... |
| 20. | Other deductions (e.g. moving expenses) | ..... |
| 22. | Subtotal (add lines 13 to 21 inclusive) | ..... |
| 23. | *Net income* (subtract line 22 from line 12) | ..... |

*Personal Exemptions*

| | | |
|---|---|---|
| 24. | Basic personal | $4,270 |
| 25. | Married ($3,740) | ..... |
| 26. | Age ($2,670) | ..... |
| 27. | Dependent children under 18 ($470 per child) | ..... |
| 28. | Dependents 18 and over (infirm: $1,470; others: $1,000) | ..... |
| 29. | Disability deduction ($2,920) | ..... |
| 30. | Subtotal (add lines 24 to 29 inclusive) | ..... |

*Other Deductions*

| | | |
|---|---|---|
| 31. | Interest & dividend income deduction (max. $1,000) | ..... |
| 32. | Pension income deduction (max. $1,000) | ..... |

33. Net medical expenses deduction .....
34. Education deduction ($50 per month in school) .....
35. Charitable contributions .....
36. Age, pension, & disability deduction transfers .....
37. Lifetime capital gains deduction .....
38. Other deductions (e.g. noncapital losses of other years) ..

39. Subtotal (add lines 31 to 28 inclusive) .....

40. *Taxable income* (line 23 minus lines 30 and 39) .....

41. Tax on taxable income (see attached schedule) .....

*Tax Credits*

42. Dividend tax credit .....

43. *Basic federal tax* (before surtax, child tax credit, and refundable sales tax credit) (line 41 minus line 42) .....

*Federal Tax Calculation*

44. Surtax .....

45. Subtotal (line 43 plus line 44) .....

46. Refundable child tax credit .....
47. Refundable sales tax credit .....

48. Subtotal (add lines 46 and 47) .....

49. Net federal tax payable (line 45 minus line 48) .....

50. *Provincial tax* (before provincial surtaxes and credits) (line 43 times provincial tax rate on attached schedule) .....

## *Illustrative Individual Income Tax Calculation Sheet: New System*

*Sources of Income*

| | |
|---|---|
| 1. Net employment income | ..... |
| 2. Old age security pension ($3,740) | ..... |
| 3. Canada/Quebec pension plan benefits | ..... |
| 4. Other pension income | ..... |
| 5. Family allowance payments ($388 per child) | ..... |
| 6. Taxable amount of dividends | ..... |
| 7. Interest income | ..... |
| 8. Net rental income | ..... |
| 9. Taxable capital gains | ..... |
| 10. Net self-employment income | ..... |
| 11. Other income | ..... |
| 12. *Total income* (add lines 1 to 11 inclusive) | ..... |

*Deductions*

| | |
|---|---|
| 13. Additional CPP/QPP contributions by self-employment (max. $496) | ..... |
| 14. RPP & RRSP contributions | ..... |
| 15. Union & professional dues | ..... |
| 16. Child care expenses | ..... |
| 17. Other deductions (e.g. moving expenses) | ..... |
| 18. Subtotal (add lines 13 to 17 inclusive) | ..... |
| 19. *Net income* (line 12 minus line 18) | ..... |

*Personal Exemptions*

| | |
|---|---|
| 20. Lifetime capital gains deduction | ..... |
| 21. Other deductions (e.g. noncapital losses of other years) | ..... |
| 22. Subtotal (add lines 20 and 21) | ..... |
| 23. *Taxable Income* (line 19 minus line 22) | ..... |
| 24. Tax on taxable income (see attached schedule) | ..... |

*Other Deductions*

| | |
|---|---|
| 25. Basic personal | $1,020 |
| 26. Married ($850) | ..... |
| 27. Dependent children under 18 ($65) | ..... |
| 28. Infirm dependents 18 & over ($250) | ..... |
| 29. Age credit ($550) | ..... |

30. Pension income credit (max. $170) .....
31. Disability deduction ($550) .....
32. Age, pension, & disability credit transfers .....
33. Tuition & education credit .....
34. Tuition & education credit transfer (max. $600) .....
35. CPP/QPP contributions (max. $84) .....
36. Unemployment insurance premiums (max. $117) .....
37. Net medical expenses credit .....
38. Charitable contribution credit .....
39. Dividend tax credit .....

40. Subtotal (add lines 25 to 39 inclusive) .....

41. *Basic federal tax* (before surtax, child tax credit, and refundable sales tax credit) (line 24 minus line 40) .....

*Federal Tax Calculation*

42. Surtax .....

43. Subtotal (line 41 plus line 42) .....

44. Refundable child tax credit .....
45. Refundable sales tax credit .....

46. Subtotal (add lines 44 and 45) .....

47. Net federal tax payable (line 43 minus line 46) .....

48. *Provincial tax* (before provincial surtaxes and credits) (line 41 times provincial tax rate on attached schedule) .....

# The Effects of Tax Reform on Business

*R.D. Brown*

## Introduction

As expected, and as required by political necessity, business has turned out to be a loser in the tax reform process. Most businessmen in Canada gave grudging initial acceptance of the broad principles behind the long-awaited tax reform proposals that the federal government released on June 18, 1987, if for no better reason than that the proposed changes seemed less devastating and less extensive than had originally been feared. But now that businessmen have had more time to study the reform package, they have become a bit more concerned about its long-term implications, particularly if there are significant delays in the implementation of the second stage of tax reform — the fundamental overhaul of Canada's perverse and creaking sales tax system.

The tax reform package is put together with finely balanced tradeoffs between economic rationality and political expediency, between immediate patching and long-term reform, between the competitive need to bring down personal and corporate tax rates and the obscene revenue requirements of the bulging government deficit, and between the differing interests of numerous pressure groups. Overall, the package stands as an excellent example of the applied art of the possible. As such, its immediate effect on business and the economy is not likely to be extraordinarily large. Its compromises do reflect that all-too-typical Canadian malaise, our inabil-

ity to deal decisively with tough issues even after they are well identified. But the package is still noteworthy for bringing into the open some of the fundamental structural problems in the tax system and for moving, however slowly and haltingly, toward their solution.

## Objectives of the Tax Reform Proposals

The fundamental philosophy behind the corporate and business tax changes is to provide a more neutral — and more efficient — tax environment. After years of frequently misguided government intervention into business decisions, the *White Paper* takes a firm first step in the opposite direction, toward a "level playing field", by reducing some business incentives and tax breaks, by trying to ensure that virtually all profitable corporations pay some tax, and by cutting corporate tax rates.

The *White Paper* claims that the broader base, reduced incentives, and lower rates are intended to reward success, not effort, but it does not carry this change in direction to the extreme. The tax system would, in fact, continue to contain some important incentives, such as research benefits, a lower income tax rate for manufacturing, and some special resource provisions. Overall, however, the changes would reduce significantly the dispersion in effective tax rates between different sectors of the economy,[1] with the objective of facilitating a more effective allocation of resources.

The *White Paper* pays lip service to a large number of other objectives in the tax reform process, without indicating any clear priorities among them. The paper's performance on each of these objectives varies. It is likely, for example, that the reforms would improve the stability of the tax system, since the reduction in front-end incentives, accelerated writeoffs, and tax shelter deductions would reduce the variability in government revenues, particularly after there has been some runoff of the present huge unused bank of tax credits and deductions. There is no simple answer to how well the tax package would achieve fairness, but it clearly deserves a failing grade on the objective of simplicity. The term-preferred share rules alone, with draft regulations and an abbreviated explanation, run to 73 pages of some of the most complex prose Ottawa has ever produced.

There are, of course, other objectives underlying the business tax changes. The reform package seeks to gain a larger amount of revenue from the business sector overall, allegedly to address the declining contri-

[1]For a table of present and proposed effective rates by industry, see Department of Finance, *Tax Reform 1987: Income Tax Reform* (Ottawa, June 18, 1987), p. 43.

bution (as a percentage of total revenue) of the corporation income tax over the past 40 years. The *White Paper* studiously ignores, however, some of the fundamental issues relating to the taxation of business income, most notably the distorting effects of inflation and the integration of corporate and personal incomes.

But these reasons for corporate tax reform are all subsidiary to one overriding practical consideration: with major tax rate cuts in the United States, nominal corporate tax rates in Canada need to be reduced sharply to prevent a substantial erosion of the Canadian tax base. Without a reduction in its corporate tax rates, Canada would see not only some service and other industries move to the United States to benefit from lower rates, but also an inevitable trend by multinational corporations to shift income to the United States, where they would bear less tax, while moving expenses to Canada, where their deduction would produce greater tax savings. Of course, in reducing corporate rates, Canada also has to revise the corporate base and deal with a broad range of personal and other tax issues.

## The Key Business Tax Changes

The tax changes that would affect business most directly include several significant base-broadening measures, substantial cuts in nominal corporate tax rates, and, perversely, some extra tax costs loaded on business for an unspecified interim period.

The *White Paper*'s overall thrust toward a more neutral tax system leads to a base-broadening package that would increase corporate taxable income from 72 percent to 84 percent of reported corporate profits,[2] while reducing the dispersion in effective rates among industry and investment sectors. The most important tax changes bearing on the corporate tax base are the proposed cutbacks in the capital cost allowance system — the depreciation allowed for tax purposes on capital assets. The *White Paper* proposes reductions in allowances on a number of assets, including buildings, contractors' equipment, and most machinery. The key allowance on manufacturing and processing equipment would be cut to a declining balance rate of 25 percent over a four-year transition period, instead of the present three-year, straight line writeoff.[3] In addition, after 1989, depreciation would be allowed only when an asset is placed in use, a change that would especially

[2]Ibid., p. 44.

[3]The present allowance, with the half-year rule, is 25 percent of the cost in the first year, 50 percent in the second, and 25 percent in the third.

slow down writeoffs and raise effective investment costs on major new projects.

These changes, when fully effective, would mean that, for the first time in decades, the effective depreciation rates on most machinery and equipment in Canada would be below those in the United States, where such writeoffs escaped relatively unscathed in the 1986 reforms.[4] These depreciation changes would cut back business cash flow significantly. Overall, these tax base changes, even with the influence of lower rates, would reduce markedly the attractiveness of new business investment in Canada.[5]

The *White Paper*'s other proposals affecting the corporate tax base include:

- replacing the current immediate writeoff of the cost of issuing of new securities with a deduction spread over the life of the debt or five years, whichever is less;
- treating interest and soft costs relating to real estate development less favorably;
- reducing reserve deductions in financial institutions, while imposing a special 15 percent tax on that portion of a life insurance company's investment income that is applicable to its new life insurance liabilities;
- introducing a tax on dividends paid on new preferred share issues, designed to make it more difficult for nontaxpaying Canadian corporations to "borrow" funds through preferred shares (at present, dividends get a preferred tax treatment unrelated to the underlying corporate tax paid by the issuer);
- phasing out depletion allowances and introducing tighter rules on the deduction of writeoffs from limited resource partnerships;
- disallowing 20 percent of the present, fully deductible cost of meals and entertainment;
- tightening rules on tax administration and enforcement, including introducing an anti-avoidance rule (although the proposed rule is vague and would add uncertainty to the tax consequences of many business transactions); and
- reducing the dividend gross-up and credit from the current 33 percent to

[4]For a more detailed commentary on the relatively more adverse Canadian changes in depreciation rates, see David Broadhurst, "Tax Reform: Raising the Cost of Capital," *Canadian Tax Journal*, 35 (forthcoming, July-August 1987).

[5]There are some indications that the overall effect of the reform proposals — including the associated phaseout of the investment tax credit — on returns on capital investment in Canada would be more severe than the effect the U.S. reforms have had on investment returns in that country (Ibid.).

25 percent in 1988, and including two-thirds of capital gains in income in 1988 — and 75 percent in 1990 — instead of the present one-half.

To a degree, these changes in the base are to be offset by significant cuts in corporate tax rates. The government proposes to reduce the general federal corporate tax rate to 28 percent (plus a 3 percent surtax) on July 1, 1988, while slowly dropping the federal rate on income from manufacturing and processing to 23 percent (plus the surtax) by mid-1991. It also proposes to standardize the federal rates for small businesses at 12 percent, plus the surtax, on the up to $200,000 of business income eligible for the small business deduction.

In combination with indicated provincial rates averaging perhaps 15.5 percent, these changes would mean a general corporate tax rate in Canada of about 44.5 percent from July 1, 1988. In the United States, in contrast, combined federal and state tax rates likely will average around 38–40 percent in 1988. But when the reduced federal tax rates on manufacturing and processing income become fully effective in 1991, the combined corporate tax rate for this key sector would drop to 37 percent — below that of the United States and thus maintaining Canada's traditional rate advantage in this most internationally competitive part of the economy.

Average tax rates in the two countries, however, can be misleading. Some U.S. states do not have corporate income taxes at all, while Quebec already has an effective tax rate of under 6 percent on corporate business income. Furthermore, the complex package of changes proposed in Canada and enacted in 1986 in the United States makes general comparisons of rates less than fully illuminating in understanding the relative corporate tax burdens in the two countries, as differences in the corporate tax base can be more significant than differences in rates. As in the past, Canada would continue to have one of the most favorable tax regimes for domestically controlled small private companies of any developed country in the world, with tax burdens in this area being substantially better than that in the United States. Of course, these special tax breaks for Canadian small businesses are limited to Canadian-controlled companies and are only available within limits; the favorable income tax rate, for example, only applies on up to $200,000 per year of active business income.

## The Effects on Business

As did the major U.S. reform of 1986, the Canadian package inevitably involves shifting tax burdens from individuals to businesses. In the aggregate, corporations would be called on to pay approximately $5 billion of

additional federal taxes over the next five years as a result of both the base-broadening and corporate rate reductions, and unless there is a major cut in provincial income taxes, they could pay almost this much again in provincial corporate taxes. This is not the place to review the appropriate balance between personal, corporate, and other taxes in Canada's total tax mix. It should be noted, however, that Canadian corporations already bear corporate taxes that are higher than the average for developing countries, both as a percent of gross domestic product (GDP) and as a percent of total taxes.[6]

Tax changes in other areas of the reform package are also expected to hit the business community hard. The proposed complex rules shifting a larger part of the manufacturers' sales tax (MST) to the wholesale level would increase sales tax revenues substantially, and these likely would fall on businesses as well as on consumers. These changes, motivated by a desire to plug the holes in the present crumbling MST, would simply serve to make a bad tax worse. Another example is the proposed 10 percent federal telecommunications tax. This new tax is expected to raise about $1 billion a year, but business likely would foot over three-quarters of the bill. Moreover, the proposal to accelerate the remittance of income tax deductions and sales taxes would mean a one-time cash loss to the business sector of over $2 billion.

An important difference between the U.S. tax reform and the proposed Canadian changes is that the U.S. measures were introduced abruptly and with little in the way of transitional arrangements. This meant that their adverse effects on business were fairly immediate — although these effects will tend to run down over time as the front-end loading inherent in any change in depreciation and timing rules works its way through the system.

In Canada, however, the *White Paper* proposes to give business generous transitional measures. Unfortunately, the other side of this coin is that tax burdens would escalate over the next four years as a number of tax

[6]According to statistics compiled by the Organisation for Economic Co-operation and Development (OECD), Canada's corporate tax burden in 1984 amounted to 3 percent of GDP, which was slightly above the OECD average of 2.9 percent and sharply above that of the United States (2.1 percent), West Germany (2.0 percent), Sweden (1.9 percent), and France (1.9 percent). Canada's corporate tax burden as a share of total taxes was also relatively high at 8.8 percent, compared with the OECD average of 7.9 percent (David B. Perry, "The Relative Importance of Taxes in OECD Countries," *Canadian Tax Journal* 34 [November-December]: 1505). Somewhat similar calculations made by the European Management Forum (*World Competitiveness Report* [Geneva, 1986], pp. 126, 167) show that Canada ranks seventh in a list of 21 developed countries in the proportion of its total taxes raised from corporate taxation.

measures — such as the phased reduction in capital cost allowance rates and the increase in capital gains tax — gradually take full effect.[7] As it was in the U.S. reforms, this increased burden would be partially disguised. Corporations would face higher cash income and other taxes as their reported profits actually improve. This is because, under deferred tax accounting, the taxes provided in corporate financial statements relate basically to the nominal corporate tax rate applied to the income the corporation reports in its financial accounts. Cutting the corporate rate therefore would mean a reduction in the reported corporate tax, even though the corporation is forced to pay a higher percentage of the tax on a current basis and will end up having its cash flow reduced.

### *The Effects on Business Financing*

The proposed tax changes would have a number of effects, most of them adverse, on the ability of businesses to raise capital.

The most significant change relates to the proposed tax on dividends paid on new issues of preferred shares. Corporations that pay taxes would largely be able to offset this new tax against their current tax liabilities; the tax, therefore, would represent no additional cost for them. But for the many corporations that do not pay taxes — due to tax incentives or economic losses — the new dividend tax would make preferred share financing substantially less attractive; such corporations would experience a sharp upward shift in the effective cost of capital. For those on the margins of economic viability, the change could prove extraordinarily damaging.

On a broader front, the proposed tax changes would confront Canadian corporations with higher tax burdens, on average, largely because of reduced capital writeoffs and higher taxes on financial institutions. At the same time, cutting the dividend tax credit from its current 33⅓ percent to 25 percent in 1988 would reduce the favored tax treatment the present tax regime affords dividends relative to other types of income. Further, increasing the proportion of capital gains that is included in income would result, by 1990, in an absolute increase in their taxation, again reducing the attractiveness of equity financing.

Under present tax law, corporate dividends and capital gains receive roughly equal tax treatment in the hands of personal investors. Following the full implementation of the reform changes in this area by 1990, capital

[7]The estimated increase in net federal revenue from corporate tax changes caused by the *White Paper* changes is anticipated to grow from $470 million in 1988 to $1,580 million by 1992 (Department of Finance, *Tax Reform 1987: Income Tax Reform*, p. 67).

gains would be more heavily taxed than dividends, creating unfortunate structural problems as well as possible adverse economic influences. There could be a relative reduction in the market perception of the value of growth companies (which are likely to create capital gains — and an increase in the value of more stable enterprises — which are likely to produce dividends. Some corporations also may consider paying out a larger proportion of their income as dividends, rather than reinvesting those earnings to be realized by shareholders as capital gains.

Canadian business, faced with lower after-tax expected rates of return on some investments (particularly greenfield plants and megaprojects), a reduced flexibility on financing methods (particularly in start-up situations), and a less favorable tax treatment of equity investments for individual investors, obviously would have greater difficulties in securing new financing under the proposed tax reform package.[8]

## Evaluating the Package

One of the difficulties in evaluating the reform package is that it would have quite different effects on different businesses. The following is a summary of some generalizations — subject to important qualifications — about the overall effects of the reform package on business:

- In general, the changes would help businesses with high profit levels since the benefits from the proposed corporate rate cuts would outweigh the additional costs incurred because of base broadening. Conversely, of course, the changes would adversely affect businesses with low or negative returns.
- Lower corporate tax rates would reduce the tax advantages of borrowing versus equity, as well as the relative advantage of highly levered financial positions.
- The reform proposals would have the most adverse effect on capital-intensive industries, since a number of the changes — the cutback in capital cost allowances being the most notable — would particularly affect capital investment.[9] Service industries and other businesses relying less heavily on

[8]The *White Paper* argues that the reform package would increase only marginally the effective tax rate on new investment (Ibid., p. 47), but this is an average calculation at best, and a considerable volume of investment would be disadvantaged.

[9]The government recognizes that the increase in corporate tax burdens "will, over the short to medium term, result in a slight increase in the user cost of capital which could be expected to generate a somewhat lower desired level of capital," but it argues that, in the long term, this could be offset by efficiency gains from a more neutral tax system (Department of Finance, *Tax Reform 1987: Economic and Fiscal Outlook* [Ottawa, June 18, 1987], p. 7).

capital investment would tend to come out of the process as net beneficiaries because of the rate cuts.

- The "put-in-use" rule would seriously reduce the expected rate of return from large new investments such as resource megaprojects.[10] (Under the "put-in-use" rule, capital cost allowances could be claimed only when assets are actually used for business purposes, instead of when costs are incurred.)
- The reform package would tend to reduce the rate of return on new investment through its less favorable treatment of capital investment. In some cases, they would also provide tax breaks (through rate cuts) on the return on old investments. This occurred in the United States, and so may be an inevitable part of any base-broadening exercise.

Because of base broadening and reduced investment incentives, effective tax rates under the reform proposals in different industries would tend to show less divergence. Important industry incentives would still be available in the resources sector, however, and to industry generally through research and development and other benefits.[11] Sectors that could benefit from the changes, primarily because of lower corporate rates, include some parts of the construction industry, retail and wholesale trade, and many service firms. Most adversely affected would be some areas of the resources sector — particularly mining, which would lose the earned depletion allowance and face lower capital writeoffs — real estate, heavy industry, and the financial sector — which apparently was singled out for special attention because a number of profitable companies are not currently paying substantial corporate taxes. Tax shelter investments, including Canadian films, MURBs, hobby farm properties, and certain resource programs, also would be hit relatively hard.

Overall, as in the United States, the Canadian reform package would bite hardest at capital-intensive, goods-producing industries — some of which are already experiencing economic problems — and would provide the most

[10] In his speech to the House of Commons releasing the *White Paper*, Finance Minister Wilson recognized the overall adverse effect on major oil and gas projects, and proposed *ad hoc* nontax assistance as an offset (Hon. Michael H. Wilson, *Tax Reform 1987* [Ottawa: Department of Finance, June 18, 1987], p. 7).

[11] According to the *White Paper*, mining, manufacturing, and real estate would bear significantly higher effective tax rates after reform, while agriculture, oil and gas, construction, wholesale and retail trade, and services are among the sectors that would benefit from the package (Department of Finance, *Tax Reform 1987: Income Tax Reform*, p. 43).

relief to the growing services sector.[12]

With regard to its regional impact, the package could result in slightly higher relative corporate tax collections from Ontario and Quebec, because of their high corporate incomes. At the same time, these two provinces, because of their high personal incomes, stand to benefit from the proposed reductions in personal taxes. The slight shift from income taxes to consumption taxes inherent in the first-stage reforms, and more strongly indicated in the second stage, could increase net tax burdens in those areas — such as the Atlantic provinces — where personal consumption is a relatively large component of income.

As a final comment in this section, it should be noted that since the reforms would increase personal after-tax income, this should have a positive effect on aggregate personal demand and thus a favorable effect on business.

## The Second Stage: Waiting for the Other Shoe to Drop

For Canadian business, the package's biggest disappointment is its failure to provide a definite timetable for the reform of Canada's antiquated and perverse sales tax system. The *White Paper* says all the right things: it argues persuasively for the adoption of a multistage sales tax, with a uniform rate on a comprehensive base and full credits for business inputs. The *White Paper* discusses three alternative forms of this tax; of these, by far the most attractive to business would be a national sales tax, involving a combined federal-provincial sales tax and thus including provincial sales taxes in the reform process.

But with all its flaws, the present federal sales tax has one monumental advantage that no government has ever been able to overlook totally: it is practically invisible to consumers. All of the rational alternatives to the present system carry with them more visibility and, therefore, more political cost. The government's splitting the fundamental sales tax revisions from the rest of the reform package and assigning it an indefinite implementation date is, therefore, a major disappointment.

The acceptance of the bulk of the first-stage tax changes, including the elimination of some cherished tax incentives, would have been much easier

[12]In evaluating the total impact of the package on Canadian industry, it is important to note that the government already had planned to phase out the general investment tax credit — formerly at a rate of 7 percent — through 1988, and that it had abolished the inventory allowance — partially to reflect the impact of inflation on current assets in 1986.

at least for the goods-producing sectors of the economy if they had been accompanied by a definite timetable for the replacement of the federal sales tax and, preferably, provincial sales taxes with a broadly based value-added tax. The adoption of such a rationalized commodity tax structure would avoid the pyramiding of tax on business inputs, remove the present penalties on Canadian-made goods that must compete with foreign-produced goods at home and abroad, and eliminate distortions caused by the random burden of the present sales tax. Further, the second-stage reforms would produce efficiency gains for the economy of a larger magnitude than those from the first stage. Canadian industry is prepared to give up a lot to get rid of the present antiquated commodity tax structure, but it now fears that it will have to pay the price long before it receives delivery.

The *White Paper* also indicates that, in the second stage, there would be a further modest shift from income taxation to commodity taxation. This would be accomplished by removing the corporate and personal income surtaxes, and by using the expansion of the role of commodity taxation to finance a further cut in personal tax burdens for middle-income Canadians. Again, however, although both the Economic Council of Canada and the Macdonald Commission have argued in favor of such a shift from income to consumption taxes,[13] the government's lack of a timetable for the second-stage reforms leaves the process in limbo.

## Provincial Reaction

Ever since the beginning of the Second World War, the federal government has largely determined the corporate and personal tax bases for both federal and provincial taxation. While three provinces — Ontario, Quebec, and Alberta — now collect their own corporate tax directly, they rely largely, although not exclusively, on the federal government's definition of taxable income and tend to follow federal tax changes. This reliance on a nationally defined tax base, together with a relatively uniform method of allocating income among the provinces, has served Canada well, and the federal government has made an effort in discussions with the provinces to retain their acceptance of the federal base.

In general, the provinces are unlikely to take strong exception to the reform proposals. By putting a cap on the lifetime personal capital gains

[13]Economic Council of Canada, *Road Map for Tax Reform* (Ottawa: Supply and Services Canada, 1987); Royal Commission on the Economic Union and Development Prospects for Canada, *Report*, vol. 2 (Ottawa: Supply and Services Canada, 1985), pp. 206-209.

exemption and by closing various perceived tax loopholes, the package would meet some provincial concerns over the existing system. It is quite possible, however, that the provinces might seek federal guarantees that the reforms would not reduce provincial revenues. With respect to the second-stage reforms, it remains to be seen whether the provinces would really be interested in incorporating their retail sales tax systems in a national sales tax, but preliminary discussions appear to be proceeding reasonably favorably.

The *White Paper* expects that the implications of the proposed changes on aggregate provincial revenues would be neutral in the aggregate, although this revenue neutrality is to be made up only through some acceleration of payments to the provinces and through additional equalization and contracting out payments, which are estimated to increase by $360 million per year by 1990.

On the corporate side, the provinces would gain substantial revenue if they maintain their corporate tax rates at existing levels but follow the federal initiatives with respect to base broadening. The *White Paper* estimates that by so doing, the provinces would extract almost $900 million per year in additional revenue by 1990. On the other hand, the provinces would need these higher corporate revenues to help offset revenue losses from cuts in personal taxes — should they follow the federal government's initiatives in that area. Ontario and, to a lesser extent, Alberta would derive net revenue increases from following the federal changes on both corporate and personal taxes because these two provinces tend to have a heavy concentration of corporate profits and personal income earned within their borders. Both provinces, therefore, may be able to cut their corporate tax rates, although it is difficult to predict what action they will take in this area.

Quebec, for its part, has relied more on personal income taxes (and other taxes) and less on corporate income taxes than have the other provinces. It has deliberately held down its corporate tax on business income to attract new investment. Accordingly, if Quebec were simply to parallel the federal government's changes, it would lose substantial net revenue: the decline in personal tax burdens would cost it relatively more, and the increase in corporate taxes would yield it relatively less, than the other provinces. Quebec obviously would have to adopt a different strategy; while it might follow most of the federal changes, it likely would find itself considering a combination of corporate rate increases and/or moderating its adoption of the federal personal rate cuts.

## The Future

The *White Paper*'s reform proposals, as they affect business, are somewhat less dramatic than one might have anticipated. However, the overall thrust toward a more neutral and noninterventionist system is one that could serve Canadians well.

The business community has two main concerns about the proposals. First, it questions whether the overall package, with its lower investment incentives and relatively higher taxes on capital income, might not have too many adverse effects on the ability of business to raise capital and on the rewards to that capital, particularly in the manufacturing sector and in relation to major new projects. Second, the business community is concerned that the package might adversely affect the international competitiveness of Canadian business. Many business people apparently feel, for example, that the changes would affect capital investment more adversely than was the case in the U.S. reforms. (David Timbrell addresses this issue separately in his contribution to this volume.)

But possibly overshadowing both of these concerns could be a deep sense of disappointment — particularly among those in the goods-producing industries — that there is no clear schedule for implementing the badly needed reform of the commodity tax system, and that the ultimate fate of these reforms is still in some doubt.

Part of the concern that business has about the tax reform package may well relate to what the package omits, rather than what it contains. The *White Paper*'s failure to provide any relief from the effects of inflation, its lack of positive action on the integration of corporate and personal incomes, and, on a broader front, the perceived failure of the government to deal with its massive deficit are all issues of major concern to business — issues that may loom with increasing importance in the years ahead.

# Tax Reform: Effects on Canada's Tax Competitiveness with the United States[1]

**David Y. Timbrell**

## Introduction

One of the most frequently stated reasons for tax reform is the need to improve Canada's international competitiveness. In *Guidelines for Tax Reform*, published in October 1986, Finance Minister Wilson stated that:

> Our corporate tax system must be responsive to the need to ensure that investment, whether by Canadians or non-residents, takes place in Canada. We must be sure that the job-creating capacity of our economy is maintained and enhanced . . . In setting the rate of corporate tax, we must also keep in mind the need to ensure that our domestic tax base is not undermined as income is shifted to countries with lower tax rates.[2]

This document pointed to two distinct sets of effects of differences between tax systems: those caused by the total impact of a system on an industry and those caused by differences in marginal rates. Businesses that are international in scope or that can operate effectively in more than one country are influenced by both factors. Differences in the total impact between two countries' tax systems lead, all other things being equal, to a

[1]I would like to acknowledge the assistance that Bradley Sakich and Keith Mosley, both of Coopers & Lybrand, have provided in the preparation of the tables and models that are an important part of this paper.

[2]Hon. Michael H. Wilson, *Guidelines for Tax Reform in Canada* (Ottawa: Department of Finance, October 1986), p. 7.

migration toward the country with the more favorable system. Differences in marginal rates, on the other hand, lead not to the migration of businesses but to international tax planning, which seeks to move income from the higher-rate country to the lower-rate country. This latter form of transaction can involve interest charges, royalties, technical service fees, management fees, and the prices at which goods are traded between countries. It can severely erode the tax base of the country with the higher marginal rates even though its tax system is in other respects favorable. It is clear that tax reform in the United States, which became fully effective in July 1987, has placed considerable pressure on the Canadian system by creating a large gap in the two countries' marginal tax rates.

This paper analyzes these two main aspects of tax competitiveness between Canada and the United States by developing some indicators of the value of pre- and post-reform cash flows. The pre-reform estimates assume tax provisions similar to those of 1985, when investment tax credits were still available in the United States and the inventory allowance was still available in Canada. The post-reform estimates assume the completion of the reform process in Canada, with commodity tax reform in place and income surtaxes removed.

## A Comparison of the Two Countries' Corporate Tax Systems

### *Marginal Tax Rates*

While international tax planning decisions seldom lead businesses to establish in a particular country or to move from one country to another, they can, however, cause potentially serious losses to the national revenue. Businesses can be deterred from making such tax planning decisions by taxes on crossborder charges that are sufficiently high to negate tax rate differentials that would otherwise exist. They can also be deterred by vigorous assessing activity to minimize the charges that taxpayers would otherwise make against income in the higher-rate country. There are limits, however, to how far such measures can go. High rates of withholding tax on interest and royalties, for example, discourage all inflows of capital and know-how, including those that are not tax-motivated.

No two countries with such close financial and trade links as those between Canada and the United States can expect their tax bases to remain unscathed if their marginal tax rates move too far apart. The U.S. tax rate changes have introduced such major differences in the two countries' rates

## Table 1

### *Corporate Tax Rates in Ontario and the United States, 1986–92*

*(percentage)*

| | Ontario | | | | | | |
|---|---|---|---|---|---|---|---|
| | **1986** | **1987** | **1988** | **1989** | **1990** | **1991** | **1992** |
| *Manufacturing* | | | | | | | |
| Federal tax | 30.00% | 29.00% | 27.00% | 25.50% | 24.50% | 23.50% | 23.00% |
| Surtax | 1.50 | 0.87 | 0.81 | 0.77 | 0.74 | — | — |
| Provincial tax | 14.50 | 14.50 | 13.50 | 13.50 | 13.50 | 13.00 | 13.00 |
| *Total* | *46.00* | *44.37* | *41.31* | *39.77* | *38.74* | *36.50* | *36.00* |
| *Other business* | | | | | | | |
| Federal tax | 36.00 | 35.50 | 31.50 | 28.00 | 28.00 | 28.00 | 28.00 |
| Surtax | 1.80 | 1.07 | 0.95 | 0.84 | 0.84 | — | — |
| Provincial tax | 15.50 | 15.50 | 14.50 | 14.50 | 14.50 | 14.00 | 14.00 |
| *Total* | *53.30* | *52.07* | *46.95* | *43.34* | *43.34* | *42.00* | *42.00* |
| | **United States** | | | | | | |
| | **1986** | **1987** | **1988** | **1989** | **1990** | **1991** | **1992** |
| *All business* | | | | | | | |
| Federal tax | 46.00 | 40.00 | 34.00 | 34.00 | 34.00 | 34.00 | 34.00 |
| State tax (net) | 4.32 | 4.80 | 5.28 | 5.28 | 5.28 | 5.28 | 5.28 |
| *Total* | *50.32* | *44.80* | *39.28* | *39.28* | *39.28* | *39.28* | *39.28* |

Assumptions for Canada:

- that the surtax will be removed when sales tax reforms are implemented (assumed to be in 1991);
- that the business does not qualify for small business rates;
- that the business is earning profits that are 100 percent allocable in Ontario; and
- that the year-end is December 31.

Assumptions for the United States:

- that in each year, the top U.S. corporate rate of tax applies (lower graduated rates have been recaptured);
- that state tax is deductible for federal tax purposes; and
- that the year-end is December 31.

Source: Coopers & Lybrand (Toronto).

that, without tax reform in Canada, the normal protective devices almost certainly would break down. One of the imperatives of Canadian tax reform, therefore, is to restore the balance. Tables 1 and 2 compare pre- and post-reform corporate tax rates in Canada and the United States. They indicate that, in 1986, a typical Canadian manufacturing business had a four point rate advantage over its U.S. counterpart, that it would have a rate

**Table 2**

***Corporate Tax Rates for Manufacturers in Selected Canadian Provinces and the United States, 1986–92***

| | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 | 1992 |
|---|---|---|---|---|---|---|---|
| Alberta | 36.50 | 34.87 | 32.81 | 31.27 | 30.24 | 28.00 | 27.50 |
| British Columbia | 47.50 | 45.87 | 42.81 | 41.27 | 40.24 | 38.00 | 37.50 |
| Ontario | 46.00 | 44.37 | 41.31 | 39.77 | 38.74 | 36.50 | 36.00 |
| Quebec | 37.00 | 35.37 | 33.31 | 31.77 | 30.74 | 28.50 | 28.00 |
| Typical U.S. state | 50.32 | 44.80 | 39.28 | 39.28 | 39.28 | 39.28 | 39.28 |

Note: The assumptions and methodology are the same as in Table 1.

Source: Coopers & Lybrand (Toronto).

disadvantage of approximately two points in 1988, and that, in 1992, it would once again have an advantage, of three points — assuming no further changes in U.S. tax rates. The tables show a similar pattern for other businesses, but with a much more severe disadvantage to Canada in 1988.[3]

In the two tables, it is assumed that provincial corporate taxes for manufacturers will fall by one percentage point in 1988 in British Columbia and Ontario and by a further one-half point in all provinces in 1991, when commodity tax reform is assumed to be in place. These reductions are based on the notion that, with substantial broadening of the corporate tax base, some provinces would be in a position to lower their tax rates to enhance their competitive position.

The current rates of, and outlook for, U.S. state taxes are more difficult to generalize. The two tables use an average (deductible) state tax of 8 percent, reflecting current rates in the following states: California (9.6 percent), Illinois (6.5 percent), Maine (8.93 percent), Maryland (7 percent), Massachusetts (8.33 percent), New Hampshire (8.25 percent), New Jersey (9 percent), and New York (10 percent). The 8 percent average rate is thus somewhat generous to the United States, but no further reductions have been assumed. For some other states, direct comparisons cannot be made. Michigan's tax rate, for example, is only 2.35 percent, but its tax base includes wages as well as profits; it is, therefore, more a value-added tax than an income tax.

[3]Different comparisons can be made depending which assumptions are used, and the reader should consult the notes to the tables carefully. Neither of these two tables includes any element of tax for the repatriation of profits from one country to the other. If all after-tax profits were repatriated as dividends, the effective rates of tax in both countries would increase by about six percentage points. The potential cost of repatriating profits is, however, a minor factor in business location decisions.

**Table 3**

***Present Values of Pre- and Post-Reform Tax Deductions for Capital Expenditures by Manufacturers in Canada and the United States***

| | Pre-reform | | Post-reform | |
|---|---|---|---|---|
| | Canada[a] | United States | Canada[a] | United States |
| Buildings[b] | $0.170 | $0.275 | $0.117 | $0.142 |
| Equipment[c] | 0.432 | 0.471 | 0.266 | 0.291 |
| Small tools[d] | 0.426 | 0.471 | 0.334 | 0.338 |
| Resource extraction assets[e] | 0.380[f] | 0.471 | 0.339 | 0.291 |
| R&D expenditures | 0.525[g] | 0.428[h] | 0.455[g] | 0.319[h] |

[a]The generalized formula used to calculate present values is:

$$\frac{(1 - \text{ITC}) \times \text{CCA rate} \times \text{Tax rate} \times (i + 1/2)}{(\text{CCA rate} + i)(1 + i)},$$

with i set at 8 percent.

[b]For Canada, class 3 assets; for the United States, 19-year life before, and 31½-year life after, reform.

[c]For Canada, class 29 assets; for the United States, 5-year life before, and 7-year life after, reform.

[d]For Canada, class 12 assets; for the United States, 3-year life before and after reform.

[e]For Canada, class 10 assets; for the United States, 5-year life before, and 7-year life after, reform.

[f]Does not incorporate 100 percent deduction against income of a new mine.

[g]Capital R&D expenditures are assumed to be fully deductible.

[h]Capital R&D expenditures are deductible over 3 years before, and over 5 years after, reform; no accelerated deductions have been assumed.

Note: Pre-reform values for purchases made in the United States refer to 1985, the last year for which investment tax credits were available in that country.

Source: Coopers & Lybrand (Toronto).

It should also be noted that the ease with which businesses are able to arrange their crossborder affairs to take advantage of differences in marginal rates places a strong constraint on Canada's ability to raise tax rates again.

### *Tax Bases*

When one country taxes particular business activities at a lower rate than does a neighboring country, those activities, if mobile, will move from the higher-rate country to the lower-rate country. Since relocation costs are substantial, such moves do not occur quickly. That having been said, however, one should not overemphasize the impact that a tax system has on such decisions; it is but one of many factors that enter into locational

decisions. Of greater absolute importance are access to markets, the quality and price of labor supply, exchange rates, and the availability of grants and remissions of levies by various levels of government. The discussion that follows assumes that all other things are equal, so as to concentrate on the impact of taxation. In the real world, however, other things can be dramatically unequal and can make the impact of two countries' tax systems relatively insignificant. Where differences in calculating taxable income can be important is in the influence they have on decisions about the location of new plants and other capital-intensive operations and about where individual executives and entrepreneurs settle.

For businesses, the most significant Canadian and U.S. tax reform measures influencing the corporate tax base are those that deal with the treatment of capital expenditures. Table 3 shows the present value of tax deductions associated with certain types of capital expenditures before and after tax reform in the two countries. The table therefore presents the discounted value of tax deductions received for a dollar's worth of capital expenditure on different classes of assets. For example, in Canada, a $1,000 expenditure on manufacturing equipment currently yields tax deductions with a present value of $432; before reform in the United States, it yielded $471. After reform, the same $1,000 expenditure yields deductions with a present value of $291 in the United States and would yield $266 in Canada. These calculations take into account allowable rates of depreciation and the availability of investment tax credits.

The main conclusions that can be drawn from these comparisons is that the reductions for manufacturing assets are similar in both countries; for resource extraction assets, the United States' advantage prior to reform has been reversed in favor of Canada; and for research and development expenditures, Canada's distinct pre-reform advantage would be even greater after reform.

### *Other Major Differences*

Some aspects of corporate taxation in the two countries afford substantially different treatment. In the United States, the option to determine inventory values using the "last in, first out" (LIFO) method of accounting yields considerable tax advantages to those businesses that tend to have increasing inventory values. Similarly, U.S. firms' ability to file consolidated returns affords welcome flexibility to offset profits and losses between different members of a corporate group, which may allow for a more rational form of corporate organization than is available in Canada. On the other

hand, the U.S. minimum tax is applicable to both individuals and corporations and may prove to be a significant levy, dampening the effect of all accelerated deductions. Changes in the rules on which costs are to be included in inventory are also adverse to U.S. taxpayers. Although any one of these factors may be significant for a particular taxpayer, useful comparisons cannot be made in general terms.

### *Overall Comparison*

Tables 4 and 5 provide estimates, based on computer-based simulations, of pre- and post-reform after-tax cash flows of a particular industrial taxpayer that might be located in either country. Although no broadly applicable conclusions can be drawn from a single example, it seems useful to synthesize the effects of rate and base changes for a typical medium-sized manufacturer.

The model assumes that a corporation invests $50 million in a manufacturing operation, partly by equity and partly by debt, on the following basis:

1. Investment is financed equally by equity and debt, and the debt bears interest at 9 percent.
2. The return on total investment is 15 percent per year before depreciation, interest, and tax.
3. The average economic life of all assets is 15 years; these assets require capital maintenance expenditures of 6.67 percent per year.
4. The composition of the $50 million investment is as follows: net working capital, $10 million; land, $4 million; buildings, $10 million; manufacturing equipment, $22.5 million; computer equipment, $2 million; small tools, $0.5 million; and Research and development capital expenditures, $1 million.
5. Eighty percent of the after-tax cash flow is retained and reinvested in the business in the same proportions as the initial investment, and the remainder is distributed as dividends to shareholders.
6. The rate of discount is 8 percent.
7. Tax rates are as shown in Table 1 for Ontario, and for a U.S. state imposing tax at 8 percent.

Table 4 shows the value of cash flows accruing to equity investment in the corporation. In addition to the base case, which employs the assumptions outlined above, four other cases are shown in the table to demonstrate the sensitivity of the estimates to alternate assumptions. In each of the five cases, the pre- and post-reform after-tax value to the corporation's share-

**Table 4**

***Present Values of Pre- and Post-Reform After-Tax Cash Flows for an Assumed Manufacturing Investment in Canada and the United States***

*($ millions)*

| | Pre-reform | | Post-reform | |
|---|---|---|---|---|
| | Canada | United States | Canada | United States |
| Base case[a] | 77.7 | 76.7 | 74.4 | 72.2 |
| "More-profitable" case[b] | 164.4 | 154.3 | 172.8 | 161.4 |
| "Higher-leverage" case[c] | 54.1 | 53.8 | 49.5 | 49.0 |
| "Labor-intensive" case[d] | 90.2 | 77.7 | 89.9 | 84.4 |
| "R&D-intensive" case[e] | 82.4 | 76.0 | 82.3 | 73.1 |

[a]Assumptions for the base case are outlined in the text.
[b]The rate of interest is assumed to increase to 20 percent.
[c]The ratio of debt to equity is assumed to be 75/25.
[d]Working capital is assumed to increase, and manufacturing equipment to decrease, by $10 million.
[e]R&D capital is assumed to increase, and manufacturing equipment to decrease, by $10 million.

Source: Coopers & Lybrand (Toronto).

holders of the 20 percent of the cash flow distributed as dividends has been calculated, and the results are presented in Table 5.

Although the results are sensitive to different assumptions, several features of interest nevertheless emerge out of the reform process in the two countries.

First, after tax reform, Canada generally would maintain the slight advantage that it enjoyed prior to the U.S. and Canadian reforms.

Second, in both countries, the combined effect of changes to the tax base and tax rates is generally to reduce after-tax cash flows by about 5 percent in the base case. In the "more-profitable" case, however, cash flows increase by about 5 percent because rate reductions have a heavier weight. In the "high-leverage" case, cash flows decline almost 10 percent, reflecting a lessening value of leverage under lower tax rates. These alternative cases show the sensitivity of the results to the particular characteristics of the investment and how it is financed.

Third, Canada's margin, while still positive, narrows in the "labor-intensive" case because the higher working capital — in relation to capital equipment — that is a feature of that case earns an inventory allowance under the pre-reform assumptions but does not do so afterwards. U.S. manufacturers have not experienced a similar loss of deductions.

**Table 5**

***Present Values of Pre- and Post-Reform After-Tax Dividends to Shareholders in Canada and the United States***

*($ millions)*

| | Pre-reform | | Post-reform | |
|---|---|---|---|---|
| | Canada | United States | Canada | United States |
| Base case | 10.2 | 7.0 | 10.5 | 9.6 |
| "More-profitable" case | 21.5 | 14.2 | 24.4 | 21.4 |
| "Higher-leverage" case | 7.1 | 5.0 | 7.0 | 6.5 |
| "Labor-intensive" case | 11.8 | 7.1 | 12.7 | 11.2 |
| "R&D-intensive" case | 10.8 | 7.0 | 11.6 | 9.7 |

Source: Coopers & Lybrand (Toronto).

Fourth, Canada's margin widens in the "R&D-intensive" case because accelerated deductions are available for all R&D capital expenditures. In the United States, such deductions are available only if they exceed a three-year moving average of R&D capital expenditures, a condition that the model assumes does not occur.

Finally, in both countries, the results for distributed profits are positive — for U.S. shareholders markedly so. The results for U.S. shareholders reflect the assumption that the marginal rate on dividends is 28 percent, rather than the effective rate of 33 percent that results from recapturing the lower rates as income exceeds U.S.$71,900 (for married individuals filing joint returns). Moreover, for U.S. shareholders (unlike Canadian shareholders), tax reform has not produced an increase in the tax base for dividends.

It should be noted that this model is limited in two important ways. First, it does not include the effects of changes in commodity taxes. It therefore favors Canada in the comparison, particularly by ignoring the new telecommunications tax. Second, it compares only the *full* pre- and post-reform situations; it does not compare the first stage of Canadian reform and U.S. reform as it is today.

## The Competitiveness of Personal Income Taxes for High-Income Earners

All other things being equal, high-income executives and entrepreneurs prefer to work in the country with the greater after-tax take-home pay. But here the *ceteris paribus* assumption is at its most courageous. Loyalty to one's country or region of birth, family ties and friendships, considerations

**Table 6**

***Pre- and Post-Reform Average Tax Rates for High-Income Individuals in Canada and the United States***

| | Pre-reform | | Post-reform | |
|---|---|---|---|---|
| | Canada | United States | Canada | United States |
| $100,000 income | 38.4% | 35.3% | 35.2% | 27.9% |
| $100,000 income and $15,000 mortgage interest | 38.4 | 28.3 | 35.2 | 22.2 |
| $100,000 income and $20,000 capital gain | 32.0 | 32.7 | 29.3 | 29.6 |
| $200,000 income | 45.4 | 43.7 | 40.0 | 33.1 |
| $200,000 income and $15,000 mortgage interest | 45.4 | 39.7 | 40.0 | 30.3 |
| $200,000 income and $50,000 capital gain | 36.4 | 39.3 | 32.0 | 33.6 |

Note: This table assumes that the taxpayer is married, has two young children, and is subject to an 8 percent deductible state tax; that incomes are in Canadian dollars for Canadian calculations and in U.S. dollars for U.S. calculations; and that, for Canadian purposes, the entire capital gain is exempt.

Source: Coopers & Lybrand (Toronto).

of lifestyle, prospects for advancement, and social welfare benefits may outweigh differences in the effective rate of tax on one's remuneration. Nevertheless, marked differences in levels of taxation can have an impact.

Table 6 shows typical effective rates of tax for high-income individuals. Both before and after tax reform, average rates of personal tax for this income group are considerably higher in Canada than they are in the United States and the tax reform process widens the gap somewhat. For example, for the individual earning $100,000, the average post-reform rate would be 7.3 percentage points higher in Canada than in the United States; under the present system, the Canadian rate is 3.1 percentage points higher. This gap would widen still further for an individual with an even higher income and if that individual paid home mortgage interest, which is deductible in the United States but not in Canada. The gap would be reduced if part of the income derives from capital gains that qualify for the $100,000 exemption. While paying higher taxes, however, Canadians receive higher social welfare benefits. Although the differentials in average rates are substantial, it remains to be seen whether the U.S. changes and those that have been proposed in Canada are sufficient to upset the former balance.

## Sales Taxes

Canadian provincial sales taxes have their equivalent in state and local taxes in the United States. Taxes at this level have no influence on Canadian-U.S. trade. The federal sales tax, however, designed in the 1920s and constantly patched and shored up since, unquestionably has hurt Canada's competitive position. It has no equivalent in the United States, and it is operationally archaic compared with the value-added taxes that other Western countries commonly use. Among its numerous weaknesses are that it is unable to relieve exports fully of their tax content, that it taxes some domestically produced goods at a higher rate than some imports, and that it offers tax advantages to manufacturers that move packaging and similar finishing operations offshore.

The options contained in the second-stage tax reform proposals are capable of dealing with many of these problems and, therefore, could have a positive effect on Canada's competitiveness. This will not happen, however, if the new tax regime embodies the sort of rate variations, statutory and conditional tax exemptions, and other administrative complexities that bedevil the present system. Until draft legislation is available, it will not be possible to judge whether full advantage has been taken of the opportunities that tax reform presents.

In the meantime, and in view of the present uncertainty about the second-stage reforms, business is more likely to be influenced by the first-stage changes to the present sales tax system. These more immediate changes appear, however, to be motivated largely by the need to increase federal revenues. They would not be applied evenly across the board — any more than is the present sales tax system — and firms that would have to pay the additional amounts will find their competitive position endangered. Another first-stage proposal, to increase substantially the tax on goods sold through related marketing companies, likely would hinder rather than help the majority of Canadian firms. It might also cause some foreign companies to reduce investment in their Canadian marketing subsidiaries, with a consequent reduction in employment.

## Conclusion

The main conclusion that can be drawn from this analysis is that the proposed changes in marginal tax rates and the tax base for both corporations and individuals are sufficiently similar to the U.S. changes that major swings of activity or of financial flows appear unlikely. Commodity tax

reform presents a major opportunity for improving Canada's competitive position. It is to be hoped that the federal government will take full advantage of this opportunity.

# Tax Reform: The Impact on Government Finances

*Edward A. Carmichael*

## Introduction

In the early stages of its mandate, the Mulroney government's fiscal priority was to reduce the federal budget deficit and to control the federal debt. It gave tax reform little emphasis, proposing only piecemeal changes to the tax system. By June 1987, when the government presented the *White Paper on Tax Reform*, its priorities had shifted to emphasize broad reform of the tax system. Although there is little prospect of significant decline in federal or provincial budget deficits, the *White Paper* adopts "deficit neutrality" as its guiding fiscal principle.

There is no question that tax reform should be accorded high priority. Effective reform can enhance Canada's international competitiveness, improve the productivity of capital investment, and lessen work disincentives that reduce the quality and quantity of labor input. But tax reform should not be given higher priority at the expense of reducing the attention given to lowering the deficit. If deficit reduction does not go hand in hand with tax reform, a worsening fiscal crisis could entirely offset the potential benefits of the reform.

The *White Paper* could have done more to address the potential complementary nature of tax reform and deficit reduction. Those who see the large federal budget deficit only as a constraint on tax reform understate this positive link. They reason that the large deficit prevents the government

from sweetening tax reform by also providing a reduction in the total tax burden. Under current circumstances, however, a more constructive attitude is to view tax reform as one element of a strategy to reduce the deficit in the fairest and least painful way possible. By strengthening the economy and broadening tax bases, tax reform can be a major part of the solution to the deficit problem.

To be fair, the *White Paper* does discuss how tax reform could increase the predictability of federal tax revenues by halting the erosion of tax bases that has occurred in the 1980s. But its dominant guiding fiscal principle is "deficit neutrality", which means that the proposed tax reforms would leave the budget deficit neither higher nor lower than it otherwise would have been.

The scope and precision of the government's pursuit of deficit neutrality is breathtaking. The *White Paper* predicts that the first stage of tax reform will add an average of just $125 million per year to the deficit over the five years ending March 31, 1992 — a period during which, it predicts, deficits will average $27 billion per year.[1] This precision also extends to the impact of tax reform on provincial government finances. While it sees some variability across provinces, the *White Paper* calculates that provincial government personal and corporate income tax revenues will be reduced by just $20 million in taxation years 1988 to 1992 — a period during which total provincial revenues are likely to exceed $500 billion.[2] The precision of these estimates is, of course, open to question. The *White Paper* bases the revenue impacts of many of the proposed tax changes on assumptions about how individuals and businesses will respond — assumptions that are uncertain at best.

The key point, however, is that even if the first stage of tax reform does turn out to be deficit neutral, the outlook for budget deficits and debt will continue to be as unsatisfactory as it is now. For this reason, a priority should be to move on to a second stage of fiscal reform that views deficit reduction and tax reform as equally important and complementary objectives.

This paper evaluates the implications of tax reform for government finances. It begins by assessing the outlook for federal government finances and the impact of the first stage of tax reform. It then looks at the implications for provincial government finances. In the conclusion, the

[1]Department of Finance, *Tax Reform 1987: Economic and Fiscal Outlook* (Ottawa, June 18, 1987), pp. 30, 36.

[2]Department of Finance, *The White Paper: Tax Reform, 1987* (Ottawa, June 18, 1987), p. 79.

paper assesses the ongoing fiscal risks associated with large government deficits and considers the role that the second stage of tax reform could play in reducing these risks.

## Tax Reform and Federal Finances

In July 1986, when Finance Minister Michael Wilson announced the federal government's intention to undertake a comprehensive reform of Canada's tax system, a plan appeared to be in place to reduce the federal deficit substantially by 1990. In the *Fiscal Plan* document released with the February 1986 budget, the government had projected that, with no further expenditure or tax changes, the budgetary deficit would fall steadily from $34 billion to $22 billion by fiscal year 1990–91.[3] In the process, the growth of federal debt would slow down so that it would no longer exceed the growth of the economy. Even though the government felt it had a credible fiscal plan in place, it warned that under unfavorable international economic conditions featuring sluggish growth and high real interest rates, there was a risk that deficits and the debt would grow out of control.

In the months following the July 1986 announcement, the federal government's fiscal situation deteriorated. The collapse of oil and grain prices, and the government's policy responses to these price shocks, quickly eliminated the prospect of a substantial decline in the federal deficit. Indeed, even assuming continued economic growth with diminishing inflation and interest rates, prospects prior to the February 1987 budget were that the federal deficit would remain stuck above $30 billion. Rather than portraying the deterioration as evidence of the urgent need for both tax and expenditure reform, the February 1987 budget downplayed it, claimed progress, and enshrined deficit neutrality as the overriding fiscal principle governing tax reform.

The *White Paper*'s medium-term fiscal plan acknowledges the full magnitude of the deterioration of federal deficit prospects since February 1986. As shown in Figure 1, by January 1987 the outlook for the deficit had worsened by over $6 billion for fiscal year 1987–88 and by about $5 billion per year over the next three fiscal years. This outlook has made tax reform decisions more difficult: the government is committed not only to a significant reduction in tax rates but also to "continuing, sizeable year-over-year reductions in the deficit."[4]

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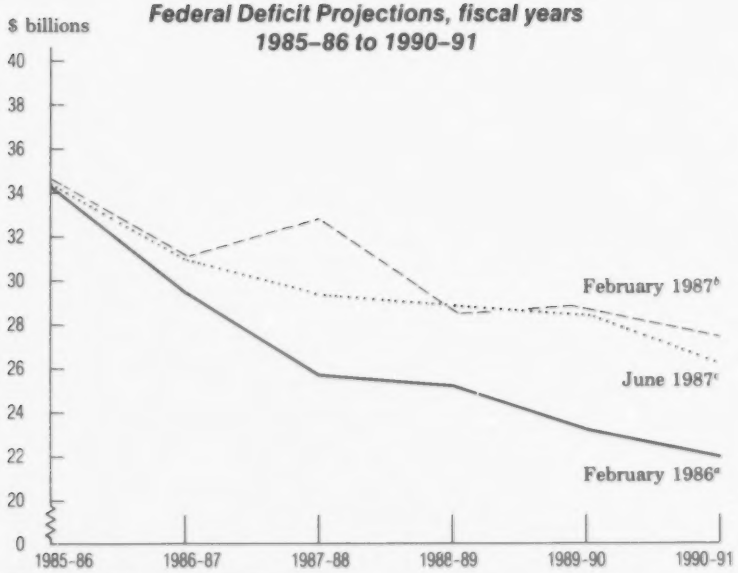
[3]Department of Finance, *The Fiscal Plan* (Ottawa, February 1986), p. 68.

[4]Department of Finance, *Tax Reform 1987: Economic and Fiscal Outlook*, p. 35.

**Figure 1**

***Federal Deficit Projections, fiscal years 1985–86 to 1990–91***




[a]Based on February 1986 *Fiscal Plan*.
[b]Excluding February 1987 budget measures.
[c]Including February 1987 budget measures and the first-stage tax reform measures.

Source: C.D. Howe Institute, based on Department of Finance, *The Fiscal Plan* (Ottawa, February 1986); idem, *Budget Papers* (Ottawa, February 1987); and idem, *Economic and Fiscal Outlook* (Ottawa, June 1987).

Yet, in the *White Paper*'s deficit projections, the government claims to have met its deficit reduction principles. Here is how: in the February 1987 budget, the government cut $2.4 billion from the fiscal year 1987–88 deficit mainly by accelerating tax payments and slowing down some defense and foreign aid expenditures. These exercises in "reprofiling" revenues and expenditures — to use the government's inelegant term — result, however, in a one-time improvement in the measured fiscal year deficit; they do little to improve the ongoing imbalance between revenue and expenditure. Still, they are sufficient to bring the projected deficit slightly below $30 billion for fiscal year 1987–88.

Nevertheless, the fiscal foundation on which to build tax reform is a weak one. If a five-year fiscal plan had been supplied with the February 1987 budget, it would have shown the deficit climbing back above $30 billion in

**Table 1**

***Projected Impact of the First Stage of Tax Reform on the Federal Deficit, fiscal years 1986–87 to 1991–92***

*($ billions)*

| | 1986–87 | 1987–88 | 1988–89 | 1989–90 | 1990–91 | 1991–92 |
|---|---|---|---|---|---|---|
| Pre-reform deficit outlook | 31.0 | 29.3 | 30.1 | 27.9 | 25.8 | 23.5 |
| Personal income tax reforms | – | – | 1.7 | 3.8 | 2.3 | 2.4 |
| Expenditure changes | – | – | 0.3 | 0.4 | 0.4 | 0.4 |
| Corporate income tax reforms | – | – | 0.5 | 0.6 | 1.2 | 1.5 |
| Post-reform deficit outlook | 31.0 | 29.3 | 31.6 | 30.9 | 27.3 | 24.8 |
| Revenue measures | – | – | -2.7 | 2.3 | -1.2 | -1.3 |
| June 1987 deficit outlook | 31.0 | 29.3 | 28.9 | 28.6 | 26.1 | 23.5 |

Source: C.D. Howe Institute, based on projections contained in Department of Finance, *The White Paper on Tax Reform* (Ottawa, June 1987), p. 76.

fiscal year 1988–89. Thus, to stick to its fiscal principles, the government proposes to raise additional revenues in the first year of the reform, but not as part of the reform itself. Indeed, as Table 1 shows, the first-stage reforms, by themselves, would reduce revenues and raise the deficit. To keep the deficit from rising, the reforms are accompanied by a series of "revenue-raising measures." Acceleration of both federal income and sales tax payments, along with a broadening of the federal sales tax base to include telecommunications, are the government's primary means of increasing projected revenue in fiscal years 1988–89 and 1989–90. These measures allow the government to project that the deficit will creep downward in each of the next three fiscal years.

It is difficult, however, to be optimistic that the current fiscal projections will be achieved, for several reasons:

• *First, the government's underlying economic projection is questionable.* Its medium-term projection calls for five more years of real economic growth averaging 3 percent, with inflation and interest rates diminishing and then stabilizing. This projection implausibly assumes not only that Canada will experience ten years of uninterrupted expansion, but also that this can occur without any resurgence in inflation and interest rates.

It is unfortunate that, unlike most recent budgets, the February 1987 budget did not include alternative economic scenarios. In the absence of such alternatives, and for the purpose of illustration, suppose that real growth in 1987 turns out to be somewhat stronger than the 2.8 percent projected in the *White Paper* but that it is accompanied by higher inflation and interest rates. (Indeed, by September 1987, this outcome looked increasingly likely.) Suppose further that stronger growth continues into 1988 and that, to keep inflation from accelerating, North American central banks are forced to raise interest rates even further, which brings about an economic slowdown in 1989. Under this scenario, the federal deficit could move up to the $35–40 billion range in the last years of this decade, rather than down to the $25–30 billion range as indicated in the current fiscal projections.

• *Second, spending pressures are increasing.* Governments always face pressures to spend more, but these pressures can be expected to grow significantly in the next two years. The federal government has not yet explicitly built ongoing financial support for farmers into its projections, yet such support may increase. This fall, the government is expected to announce its plans for expanded child care financing, while in its *White Paper on National Defence*, the government committed itself to increased purchases of defense equipment. In the run-up to the next federal election, spending pressures are likely to intensify further.

• *Third, the accuracy of tax reform impact estimates is questionable.* The government assumes that, when reforms are fully phased in, personal and corporate income tax rate reductions will reduce federal revenues by almost $7 billion per year; broadening of income tax bases is expected to increase revenues by $5.5 billion. To arrive at these estimates, the government has had to make many assumptions about how individuals and firms will respond to the reforms. While the revenue losses arising from tax rate cuts can be predicted quite accurately, the accuracy of the estimated revenue gains from base broadening is less certain. For example, will the introduction of new anti-avoidance measures in the corporate income tax generate $500 million per year in additional revenue, as the *White Paper* projects, or will firms find new ways to minimize taxes? Will the increased taxation of capital gains in the personal income tax generate an additional $300 million per year, or will risk taking be discouraged enough to reduce this projected gain? These and other questions cannot yet be answered, but there is a risk that the revenue gains from base broadening may be less than the government projects. There is the further possibility, mentioned in Tom

**Table 2**

***Consolidated Provincial and Local Budget Balances, by Province, 1980 and 1983–86***

*($ millions)*

| | 1980 | 1983 | 1984 | 1985 | 1986 |
|---|---|---|---|---|---|
| Newfoundland | 166 | 330 | 212 | 184 | 171 |
| Prince Edward Island | 13 | 11 | 5 | 15 | 17 |
| Nova Scotia | 152 | 303 | 414 | 368 | 409 |
| New Brunswick | 96 | 270 | 230 | 219 | 233 |
| Quebec | 1.303 | 1.294 | 1.781 | 1.277 | 1.444 |
| Ontario | 877 | 2.003 | 1.035 | 2.349 | 1.507 |
| Manitoba | 127 | 404 | 351 | 455 | 476 |
| Saskatchewan | 172 | 237 | 536 | 487 | 444 |
| Alberta | 2.733 | 1.024 | 1.940 | 447 | 3.028 |
| British Columbia | 241 | 1.216 | 962 | 907 | 967 |
| *Total* | *40* | *4.929* | *3.567* | *5.785* | *8.698* |

Source: Statistics Canada, Public Institutions Division.

Courchene's paper in this volume, that the government will revise some of its proposals, following parliamentary committee suggestions, in ways that reduce base broadening to some degree.[5]

It should not be surprising that the risks associated with the federal fiscal outlook remain on the side of higher deficits and debt. Since the *White Paper* does not explicitly recognize deficit reduction as an objective of tax reform, the prospects for reduced deficits are not much better today than they were before the *White Paper*'s release. By adopting deficit neutrality as a dominant principle of tax reform, the government has given up a potent weapon for cutting the deficit and slowing the growth of the debt.

## Tax Reform and Provincial Finances

As it did for federal finances, the outlook for provincial government finances also deteriorated in 1986. The consolidated budgetary deficit of provincial, territorial, and municipal governments increased to $8.7 billion in 1986 from $3.6 billion in 1984. This deterioration has offset most of the progress the federal government has made in reducing its own deficit. In the United States, in contrast, state and local governments are in a budgetary surplus position.

Changes in budget balances have varied substantially across provinces in

[5]See Thomas J. Courchene, "Tax Reform: The Impact on Individuals," in this volume, p. 25.

**Table 3**

***Projected Impact of the First Stage of Tax Reform on Provincial Revenue, 1989 and 1992***

*($ millions)*

| | 1989 | 1992 |
|---|---|---|
| Newfoundland | 8 | 2 |
| Prince Edward Island | 2 | 0 |
| Nova Scotia | 10 | 5 |
| New Brunswick | 10 | 4 |
| Quebec | 188 | 155 |
| Ontario | 18 | 227 |
| Manitoba | 7 | 14 |
| Saskatchewan | 7 | 11 |
| Alberta | 8 | 83 |
| British Columbia | 35 | 18 |
| *Total* | *278* | *209* |

Source: Department of Finance, *The White Paper on Tax Reform* (Ottawa, June 1987), p. 79.

recent years, as shown in Table 2. Most provinces have experienced either modest progress or virtually no change in their consolidated provincial and local budget deficits. However, the four western provinces' consolidated budget deficit has risen to $4.9 billion in 1986 from $0.8 billion in 1983. The worst deterioration has taken place in Alberta, where oil and grain price declines have hit hardest. But Manitoba and Saskatchewan also have been struggling to keep their deficits from rising under adverse economic circumstances. What is less understandable and justifiable is that provincial and local governments in Central Canada — Ontario, in particular — have not further reduced their budget deficits, considering the economic boom that prevails in that region.

At first glance, the *White Paper*'s estimates of the impact of first-stage tax reforms on provincial government revenues seem to suggest that it will be negligible. The estimate for taxation year 1990, for example, is that the revenues of provinces and territories other than Quebec will increase by $160 million while Quebec's revenues will decline by $165 million, resulting in a net reduction of just $5 million in provincial revenues — virtually exact revenue neutrality!

In spite of this, the *White Paper* projects considerable differences in the impact on individual provinces, as shown in Table 3. One major factor is the uneven distribution of corporate tax revenues across provinces. Ontario and Alberta normally collect a disproportionate share of provincial corporate

**Table 4**

***Projected Impact of the First Stage of Tax Reform on Provincial Revenue Sources, taxation year 1990***

| Revenue source | Change in revenues ($ millions) |
|---|---|
| Personal income tax | 1,275 |
| Corporate income tax | 885 |
| Established Programs Financing and contracting-out cash | 360 |
| Equalization | 25 |
| *Total* | -5 |

Source: Department of Finance, *The White Paper on Tax Reform* (Ottawa, June 1987), p. 78.

tax revenues because of the concentration of taxable corporations in those provinces. The federal estimates suggest that, in the early years of tax reform, all provinces will lose more in personal tax revenues than they gain in corporate tax revenues. But after several years, those provinces with a relatively large share of corporate taxes will benefit from greater corporate tax revenues as base-broadening reforms take hold. Thus, the *White Paper* calculates, Ontario and Alberta will turn out to be winners. Quebec will be the major loser, mostly because of the lowering of that province's relatively high personal income tax rates. The federal tax reforms will not help most provinces to reduce their budget deficits; ironically, Ontario, the province with the largest fiscal gain, is the one that might be doing the most to eliminate its deficit.

When one examines the *White Paper*'s estimates of provincial revenue impacts more closely, it becomes clear that the apparently precise revenue neutrality is highly dependent on assumptions about the economic outlook and how individuals, firms, and provincial governments will respond.

First, it is difficult to accept at face value the optimistic economic scenario that underlies all the revenue estimates. If the economy does not perform well, the impact of the tax reform on provincial revenues may be more negative than the *White Paper* implies. The reason is that, as shown in Table 4, the provinces must rely on substantial increases in corporate income tax revenues to balance losses of personal income tax revenues. If the economy continues to grow relatively strongly, substantial corporate tax revenue increases may materialize. If the economy experiences a downturn, however, corporate taxable incomes likely will be hit hard, and provincial increases in corporate tax revenues may be insufficient to offset

personal tax revenue losses. Put another way, tax reform could increase the downside risks to provincial revenues of an economic slowdown.

Second, the accuracy of the estimated revenue neutrality depends, among other things, on the response of the private sector. Will individuals work more? Will firms invest as much as the federal government assumes? These responses cannot be estimated with great precision.

Third, the revenue estimates depend on assumptions about how provincial governments will respond. The *White Paper* assumes that provinces other than Quebec will maintain their current personal income tax rates; that all provinces will maintain their corporate tax rates, and that Ontario, Quebec, and Alberta, which administer their own corporate tax systems, will adopt all federal base-broadening measures; and that Quebec will adopt personal tax reforms equivalent to 80 percent of the reduction in basic federal tax in that province.

These assumptions may not bear out. This is not a criticism of the *White Paper*, the authors of which had to choose some reasonable assumptions about provincial responses. But early reactions indicate that most provinces are cautiously concerned about the revenue impacts of the first-stage reforms. Some of the Atlantic provinces are concerned about revenue losses in the second year of reform and could feel compelled to raise provincial income tax rates to prevent their budget deficits from rising. Many provinces feel that sizable losses of personal tax revenue are guaranteed but that increases in corporate tax revenues are less certain. Ontario may not wish to accept all of the federal base-broadening measures; alternatively, if it does accept them, it may choose to reduce its corporate tax rate. To remain competitive, Quebec, Alberta, and other provinces may feel compelled to match Ontario's move.

In summary, provincial government finances have deteriorated recently, particularly in Western Canada. Although the *White Paper* estimates that the first-stage tax reforms will have virtually no impact on overall provincial revenues, it projects that Ontario and Alberta will gain revenues while Quebec will lose. Most provinces view these estimates with caution. They are concerned that if the economy does not continue to grow as strongly as the *White Paper* projects, or if tax revenues do not respond as projected to base-broadening measures, their budget positions could be more negatively affected.

## Continuing Fiscal Risks and the Second Stage

The first stage of tax reform has not improved the unsatisfactory fiscal prospects facing Canadian governments. While this is hardly surprising, given that the *White Paper*'s guiding principle is deficit neutrality, it makes continuing large budget deficits no less worrisome for Canada's economic prospects.

I have argued that, under current circumstances, Canadians should view deficit reduction and tax reform as complementary and interrelated objectives. Both are desirable means of strengthening the Canadian economy and reducing its vulnerability to slower growth or higher interest rates. Neither deficit reduction nor deficit-neutral tax reform alone can resolve Canada's fiscal and economic problems. But together they can make a significant contribution to improving economic performance.

For this reason, the second stage of tax reform — including reform of the federal sales tax and further reductions in personal and corporate tax rates — should be pursued with urgency. The economic impact would be significant and in the right direction. Capital investment would be encouraged, providing a foundation for stronger economic growth. The improved international competitiveness that sales tax reform would produce would have a positive effect on Canada's trade balance and employment growth. The combination of stronger national income growth and the introduction of a broadly based sales tax could reduce budget deficits. Indeed, the potential benefits of the second-stage reforms may be sufficient to justify the sacrifice of some short-term progress in reducing budget deficits in order to strengthen Canada's economy, broaden its tax base, and, in the process, reduce the vulnerability of heavily indebted Canadian governments.

Conventional wisdom holds that the chances are miniscule that the current federal government will move ahead with the second stage prior to the next election. Thoughtful Canadians need to consider, however, the implications of this assertion. If ways cannot be found to move ahead with a second stage of tax reform that strengthens the economy and reduces government deficits, Canadians face the risk of a fiscal crisis that will precipitate much more painful choices in the years ahead.

# Sales Tax Reform: The Postponed Part of the Package

*John Bossons*

## Introduction

The current federal sales tax is a hidden tax on manufacturers, and many consumers do not realize how much the tax increases the prices they pay for the goods they buy. Nevertheless, the federal government receives $13 billion annually — almost 20 percent of federal tax revenues — from this tax.

While it is unglamorous, reform of the federal sales tax is long overdue; indeed, it is in greater need of reform than the federal income tax. It is obsolete, difficult to administer and enforce, and arbitrary. It has a perverse effect on economic growth, penalizing exports and subsidizing imports. It distorts consumption choices unnecessarily. Reform will become even more important as a result of the free trade agreement signed by Canada and the United States.

An additional factor adding to the urgency of federal sales tax reform is that the growing complexity and internationalization of patterns of distribution is making enforcement progressively more difficult, resulting in an increasing degree of avoidance of the tax. The tax is becoming increasingly arbitrary and unfair, and is more and more borne by smaller manufacturers with access to fewer avenues of tax avoidance. The revenue losses from avoidance mean that other tax rates have to be increased to compensate.

The federal government's two-stage agenda for tax reform sets out a timetable for sales tax changes that is very different from the timetable for

income tax changes. In the first stage, income tax reforms are to be introduced this fall and, presumably, enacted early in 1988. By contrast, over the same period, the federal government proposes to extend the manufacturers' sales tax (MST) to raise an additional $1.1 billion of revenue. By increasing the relative importance of the MST, however, this first stage worsens the economic problems associated with the tax.

The second stage, which is to be implemented at some subsequent time, includes reform of the sales tax. The Minister of Finance has proposed three alternatives to the existing tax, all of which would mean substituting a broadly based sales tax for the current tax on manufacturers. The base of the federal sales tax would be extended to include all retail sales, and services as well as goods. In addition, the federal government is canvassing the provinces to see if the retail sales tax they now collect can be integrated into a new national sales tax.

With or without provincial participation, reform of existing sales taxes can have important redistributive and economic effects. The purpose of this paper is to outline the pros and cons of a broadly based sales tax, to evaluate the redistributive effects of sales tax reform, and to discuss the timing and implementation of a new sales tax.

In discussing sales tax reform, it is important not to lose sight of the primary consideration that an alternative to the current federal sales tax must be found. The MST has many defects and imposes an unnecessary burden on the Canadian economy. Any reasonable alternative is far superior to the existing tax.

Nevertheless, it is easy to get lost in the details of sales tax reform. Each of the government's three alternatives can be implemented in a variety of ways and with a variety of possible accompanying changes in income taxes and transfer payments. Media attention inevitably will focus on arguments about the merits of different alternatives and on the likely success of federal-provincial negotiations regarding the feasibility of a national sales tax. One of the major costs of postponing sales tax reform to a future second stage and of not announcing a firm reform program is that public discussion will remain unfocused and confused.

While some people allege that there may be political advantages to postponing sales tax reform, such an appraisal may be short sighted. Since the federal government is committed to undertake the reform, uncertainty about its nature and timing could raise the level of public anxiety. The concluding section of this paper thus sets out a decisionmaking strategy to implement sales tax reform quickly and decisively.

## Why Is Sales Tax Reform Necessary?

The existing manufacturers' sales tax places an unnecessary burden on the economy. On average, it imposes the equivalent of an approximately 3 percent tax on net manufacturing exports. Imports are subsidized and exports are penalized, which is perverse. Indeed, Canada is virtually the only major trading country still maintaining a sales tax regime that discriminates against exports.

The MST drives up the cost of manufactured goods by singling them out for taxation. It is one of the reasons why manufactured goods are more expensive in Canada than in the United States. The tax distorts consumer choices, with no offsetting benefit for the Canadian economy.

Beyond this, the MST is uneven in its application to firms. A 1985 study conducted by Woods Gordon for the Department of Finance found that effective tax rates on products varied substantially across firms even within the same industry. In one case (auto parts), effective tax rates on final sales prices ranged from a low of 4.3 percent to a high of 13.3 percent.[1] There is no rationale for such a substantial variance in tax rates; it creates unnecessary uncertainty, reduces competition, and discourages the location of new manufacturing establishments in Canada.

The inherent arbitrariness of a tax on the manufactured component of a product makes it inevitable that such a tax be uncertain in its application and complex to administer. This is why every major trading country — other than Canada and Australia — has replaced such taxes by a broadly based sales tax levied on the retail price of goods or services. The MST is inherently arbitrary because it depends on being able to identify which components of cost are manufacturing costs. In addition, the multiplicity of tax rates (zero, 8 percent, 12 percent, and 15 percent) requires tax administrators to face an unending sequence of boundary problems in deciding the categories to which products are assigned.

Domestically, the tax favors firms that can avoid or reduce it by artificially separating out elements of product cost so as to reduce costs subject to tax. It also favors large retailing firms that sell private brands, since it is relatively easy to reduce taxable manufacturing costs on such products. The tax thus favors large retailers over small firms, reducing competition and making it harder for new retailers to become established.

The arbitrariness of the tax further contributes to the burden placed on

[1] Woods Gordon, *Federal Sales Tax Survey*, a study conducted for the Department of Finance, in Department of Finance, *Tax Reform 1987: Sales Tax Reform* (Ottawa, June 1987), p. 13.

new and small firms. A complex tax is always relatively less onerous on a large firm, which can spread accounting and legal costs over a larger volume of sales. The compliance costs associated with the tax are substantial, particularly for small manufacturers that obtain inputs from abroad. Indeed, the complexity, uncertainty, and compliance costs associated with the tax are a greater disincentive than the tax rates themselves. The MST discourages the establishment of new manufacturing firms in Canada.

All in all, one can say nothing in favor of the MST as a way of taxing sales. The tax undoubtedly seemed appropriate when it was introduced in 1924. It is an expensive anachronism in today's complex, internationally oriented economy.

## Reform Alternatives

The federal government's three alternatives for sales tax reform have much in common. These common elements are much more important than the differences among the alternatives.

First, all three reform alternatives would move to a new, more uniform, broadly based tax on the retail value of goods and services purchased for domestic consumption. Ideally, such a tax would be levied on all goods and services that Canadians consume, whether imported or produced domestically. Again ideally, it would be levied on all goods and services at the same rate and thus be the same fraction of the final price to the consumer in all cases. The advantage of making a broadly based sales tax universal, with but a single tax rate, is that such a tax is relatively simple to administer and nondistorting in its effects.

Second, all three alternatives would tax goods and services on a consumption basis. Business inputs would not be taxed. By exempting exports and taxing imports, such a reform would treat exports and imports the way other countries do, and it would remove the penalties on exports and subsidies of imports that the existing MST implicitly imposes.

Third, all three alternatives are forms of a multistage sales tax. There are substantial administrative advantages in levying a sales tax on all of a company's domestic sales, rather than distinguishing between types of sales. To convert such a tax into one that is limited to consumed goods and services, it is necessary only to provide a credit to the seller for sales taxes paid by other companies on goods and services purchased by the seller. (Such a credit can be provided in one of several forms and, in fact, may be implemented in the form of a deduction in calculating taxable sales.) A sales tax levied in this way is called a multistage tax since a taxable transaction

may occur at every stage of processing, from manufacturer through distributor to retailer. The amount of tax levied at each stage would be proportional to the value added to the good or service in that stage — in other words, to the difference between the value of sales and the value of purchases. Because of its administrative advantages, a multistage, value-added tax (VAT) has become the almost universal way in which Canada's trading partners implement broadly based national sales taxes.

All three sales tax reform alternatives thus call for some form of multistage, broadly based, value-added tax. The tax levied on each stage of processing and distribution, when summed across stages, would be proportional to the value of the final sale to the consumer. Such a tax would be equivalent to a retail tax levied only on the final stage of distribution. The multistage VAT has two principal advantages over the equivalent retail sales tax. First, it is much easier to avoid taxing business inputs and, second, it is easier to enforce. Compliance costs can also be lower, provided that the VAT is levied at a single, uniform rate. The ability to ensure that business inputs are not taxed is a significant advantage of the VAT.

The differences between the three alternatives reflect two possible sets of choices: (i) whether to extend sales tax reform to incorporate the existing provincial retail sales taxes, and (ii) whether to reduce the uniformity of a broadly based sales tax by exempting selected goods and services.

One of the government's proposals is to establish a single national sales tax that would have a uniform tax base across provinces. As with the current income tax, provincial sales tax rates would vary even though the base would be uniform.

There are three potential advantages in going beyond a purely federal reform to a national sales tax. First, it would reduce administrative costs by eliminating the duplication implied by separate provincial and federal sales tax administrations. Second, integration of the provincial sales taxes into a single federal-provincial multistage VAT would create a common base for sales taxation across the country, thus reducing compliance costs for business. Third, as a by-product, moving to a national sales tax would reform provincial sales taxes by making them more broadly based and more uniform; the same revenue would be raised with lower tax rates. Business inputs would no longer be taxed by the federal government *or* by the provinces.

If it is not possible to implement a national sales tax, then sales tax reform would be limited to the federal sales tax. In this event, the federal government's other two reform proposals outline alternative ways — differing only in the breadth of the tax base — in which to implement a

multistage VAT. Advancing the two proposals served primarily to illustrate the benefits of making the tax base as broad as possible while also illustrating that a more narrowly based tax is a viable alternative.

All three alternatives imply substituting a tax on the retail value of goods and services for the current tax on the manufactured component of goods sold. While the alternatives differ in the uniformity of their application, moving the base of the federal sales tax to the retail level is essential to eliminating the worst distortions caused by the current tax. Even the more narrowly based alternative is far superior to the MST. It is important to emphasize this. Any one of the government's three reform proposals would yield substantial potential gains.

## The Pros and Cons of a Broadly Based, Uniform Sales Tax

The key issue in evaluating the three sales tax proposals is their breadth and uniformity of coverage. In practice, it is not possible for political reasons to implement a new sales tax without some exemptions. For example, even the broadest of the three alternatives would exempt residential rents. Many interest groups will seek additional exemptions, some of which politicians may find hard to resist. Each exemption, however, would introduce distortions and make the sales tax more complicated.

The most important advantage of making a new sales tax apply to *all* goods and services consumers purchase is that such coverage would make the tax simpler and less onerous to business. Arbitrary distinctions in a tax system primarily benefit the lawyers and accountants who advise clients on how to avoid taxes. From a business viewpoint, such distinctions add to compliance costs, cause distortions, and make taxes more uncertain. Many of the cost increases that result from this complexity and uncertainty end up being passed on to the consumer.

A second advantage of making the sales tax as broadly based as possible is that it would reduce distortions of consumer choices. It is not possible to eliminate all such distortions, however, because self-supplied services — such as household production and other uses of leisure time — would not be taxed. Nevertheless, the more broadly based the tax, the less distorting it will be under virtually all circumstances.

A third advantage is that the broader the base, the lower the rate of tax needs to be to raise the same amount of revenue. The distortions caused by the remaining exemptions become less important as the rate of tax diminishes.

The most serious arguments against a broadly based sales tax reflect

fears that sales tax reform would result in higher taxes for low-income households. Whether such fears are justified or not, the fact that they exist will influence political decisions.

A broadly based sales tax can be made more progressive by combining it with a refundable tax credit or additional transfer payments to low-income households. As part of the second stage of tax reform, the federal government proposes to implement a refundable tax credit and to pay for the revenue cost of this credit through an increase in the rate of federal sales tax. While the amount and precise form of the refundable tax credit are not spelled out, the principle of a compensatory tax credit is an integral part of the government's proposals. A refundable tax credit and/or increases in transfer payments clearly is the most efficient way of making low-income households better off. The alternative of exempting some categories of purchases that low-income households make in greater quantity would cost more in lost tax revenue to produce the same relief for low-income households.

Having said this, one should recognize the difficulty of changing widely held public perceptions that "necessities" should not be taxed. A uniform tax on the retail value of goods and services would be new to Canada. The retail sales taxes that provincial governments impose typically exempt many food products, children's clothing, prescription drugs, and most services. Attempts by the provinces to reduce such exemptions generally have proven to be politically costly.

Doing something new always involves some political cost, since opposition parties can be counted on to exploit the public's fear of the unknown. In the case of sales tax reform, both federal opposition parties have already attacked the government for suggesting that food might be taxed. Unfortunately, the taxation of food has a symbolic value that may easily outweigh any rational discussion of the merits of an efficiently designed sales tax. Reflecting these political difficulties, the Minister of Finance announced in December 1987 that the proposed national or federal sales tax would not be applied to essential food products or prescription drugs.

A comprehensive, uniform, broadly based sales tax, accompanied by a substantially offsetting refundable tax credit and/or transfer payments, could easily be designed to be more beneficial for low-income taxpayers than a sales tax that exempted food products, prescription drugs, and children's clothing. Obviously, there would be disagreement about how large the refundable tax credit needs to be to ensure this result. But claims that a tax on food coupled with a refundable income tax credit is necessarily regressive reflect either ignorance or hypocrisy.

Nevertheless, in politics, perceptions are often more important than facts. A new multistage tax on the retail value of goods and services almost certainly would be more widely accepted if it exempted "necessities". In addition, it would be easier to persuade the provinces to incorporate their retail sales taxes into a national sales tax if some of their existing exemptions of "necessary goods" were carried over into the new tax.

Thus, there are strong political arguments in favor of having important categories of exemptions in any new sales tax, whether the tax is a federal VAT or a federal-provincial national sales tax. Indeed, one advantage of contemplating the exemption of "necessities" is that doing so may increase the likelihood of the provinces' accepting an integrated federal-provincial VAT. From almost any viewpoint, such a tax, with a single common base that exempted food and prescription drugs, would be better than combining a comprehensive, uniform, federal VAT with existing provincial retail sales taxes.

Even with such exemptions, a VAT that included services in its base would be more broadly based than existing provincial sales taxes and substantially more broadly based than the current MST. While the scope of such exemptions should be kept as narrow as possible, the introduction of a limited range of exemptions would not lessen significantly the gains from sales tax reform, particularly if the exempted goods or services were necessities for which demand is relatively price inelastic. The major gains from reform would come from the adoption of a retail-level tax base, the elimination of taxes on business inputs, and a broadening of the range of consumer goods and services subject to tax. The gains from the first two sources would be material even if the range of consumer goods and services subject to tax were not broadened at all.

Exempting food products and prescription drugs will make the administration of a VAT more difficult than if the tax had no exemptions. While arbitrary distinctions between products would be necessary, the nature of the arbitrariness would at least be familiar if the exemptions closely matched existing provincial exemptions.

Administration of such a VAT would also require the invoice method, whereby taxes paid on purchases would be identified on invoices and credited against taxes on sales, with the invoice data providing the basis for audit. However, the administrative advantages of avoiding the invoice method are not all that substantial unless a VAT is truly all-inclusive. Even the broadest of the government's proposals does not meet this standard. Consequently, firms would still need to distinguish between creditable and noncreditable inputs, and the tax administration would still need to be able

to audit firms' classifications. The invoice method simply would formalize this requirement. In any case, the invoice method would be required with an integrated federal-provincial VAT because of the necessity of dealing with varying provincial sales tax rates. Even if the provinces initially maintained their separate taxes, there would be an advantage to starting off with an administrative set-up that could easily be integrated with provincial tax administrations at a later date.

In sum, the greatest gains from sales tax reform would come from moving to a VAT with no exemptions. Since such an ideal is almost certainly unachievable, too great a commitment to it could prejudice both the likelihood of federal sales tax reform and the possibility of an integrated federal-provincial sales tax. A VAT that exempted a limited range of "necessary" goods would still bring important economic gains for both businesses and consumers, particularly if existing provincial retail sales taxes were integrated into the new tax.

## Implementation Issues

Many of the detailed issues that need to be addressed in implementing a VAT are set out in a lengthy technical appendix to the government's proposals. Of the more contentious implementation issues, the most important concern the treatment of exempt products and the taxation of financial services, nonprofit institutions, real estate, farms, and imported nonfinancial services.

### *Input Credits on Exempt Goods and Services*

In implementing a VAT, there are generally two ways to treat exempt goods and services. One way is to make the effect of such an exemption the same as it would be under the equivalent retail sales tax. Under this "tax-free sale" approach, the seller of an exempt product would be permitted credit for tax paid on all business inputs, since such credit would be required to make the effective tax rate on exempt goods zero when summed across all stages of production and distribution.

Another approach is to restrict the exemption to the value added by the seller of the exempt product. Under this treatment, which the government seems to favor in its proposals, a business would not be permitted credit for taxes paid on purchases of goods that are exempt when sold. This approach would make the effective tax rate on such goods proportionate to the ratio of purchase price to selling price, and so make the exemption only partially effective.

Apart from the issue of whether a partial exemption would be adequate, there are three disadvantages to the second approach. First, there would be obvious administrative difficulties in having to distinguish business inputs attributable to exempt goods. Second, it would be necessary to impute tax on self-supplied business inputs to reduce biases toward self-supply. Third, even with such imputations of tax, it would introduce distortions of business choices. By making the amount of the exemption depend on the retailer's margin, it would provide a material incentive for vertical integration. As a by-product, it would subsidize large retailers that are able to integrate backward into previous stages of distribution and production, and so levy a relatively higher tax on small retailers.

The second approach, however, does have two advantages. First, as a consequence of reducing the effectiveness of exemptions, it would reduce their distorting effect on consumer choices. Whether this effect is important would depend on the nature of the exemptions and on the price elasticity of demand for the exempt items. Second, the lessened effectiveness of the exemptions would mean a smaller revenue loss, permitting a lower rate of tax on the goods and services that are taxed — it is almost always possible to increase revenue by making a tax more arbitrary.

The best method of dealing with exemptions is to avoid them. If exemptions are to be made, however, it is better in most cases to bite the bullet and make them uniformly free of tax. This would mean allowing input tax credits on all business inputs, with tax refunds to sellers whose business inputs taxed in previous stages of production and distribution exceeded taxable sales.

### *Financial Services*

Implementing a VAT on financial services would cause major difficulties for three reasons. First, there is an issue of principle as to whether they should be included at all in the base of a VAT that is intended as a tax on domestic consumer expenditures. Second, it would be difficult to separate financial services payments from interest payments, and difficult to administer a tax on such services if it does not also apply to business inputs. Third, it would be impossible to tax foreign financial institutions; it thus would be difficult to impose a tax on financial services that would not subject Canadian financial institutions to an unwarranted competitive disadvantage.

A key feature of a consumption-type VAT is that the base of the tax does not include interest receipts or other returns on financial assets. Moreover, businesses cannot deduct interest costs or dividends in computing liability

for a VAT. Net investment income is taxable under the income tax. If investment income were taxable under a VAT, the tax would cease to be a tax on consumption.

The first difficulty that arises in dealing with financial services is in isolating those that are of a consumption nature. For banks, trusts, and loan companies, the government proposes to tax the margin between interest income and interest expenses after allowing a deduction for the imputed cost of equity funds. The rationale advanced for this proposal is that the remaining margin would represent the value added by financial institutions in providing intermediation services.

The problem with this rationale is that financial intermediation does not represent current consumption but, rather, a component of the cost of capital to firms. Individuals could lend directly to firms and bear the firm-specific risk and related administrative costs, in which case their interest income would include compensation for these risks and costs. Alternatively, by using intermediaries, investors could take advantage of the economies of scale that arise in pooling risks and sharing administrative costs. A tax on financial intermediation would be particularly distorting because it would discourage investors from seeking efficient means of pooling risks.

The second difficulty in applying a VAT to financial services is in preventing a tax on financial intermediation from also applying to business inputs. In general, there are two ways in which a VAT can deal with business inputs. Either they are not taxed, in which case their cost is not deductible, or they are taxed to the seller and deductible to the purchaser. The problem is that, under the government's proposals, business inputs would not be treated consistently. In the case of interest charged by financial institutions, the imputed financial services component would be taxable for the financial institution, but not deductible for the borrower. For most other financial services, the same asymmetric treatment would occur. (The only proposed exception is property and casualty insurance premiums, on which taxes would be creditable.)

The third difficulty is that a VAT on financial services would be levied only on services provided by Canadian financial institutions. The increasing internationalization of world capital markets makes it easy to avoid this tax, since the net interest margin accrued on financial transactions with foreign financial institutions would not be subject to a VAT. Canadian financial institutions thus would have an incentive to locate financial services abroad. To deal with this problem, the government proposes to prescribe imputed fees and commissions on which taxes would be paid by the purchaser on a self-assessment basis. There are obvious difficulties in enforcing this

requirement for individuals and smaller firms, which implies that such taxes likely would not be paid except on large business financings and pension investment transactions.

For all of these reasons, the tax base of the proposed VAT should exclude financial services. Financial institutions should be taxed on charges for nonfinancial services and should receive full credit for taxes that suppliers pay on business inputs used in providing nonfinancial services.

### *Nonprofit Institutions*

The proposed VAT would exempt noncommercial services provided by hospitals, governments, universities, and other nonprofit institutions. The exemption would be only partial, however, in that goods and services purchased by such institutions would be subject to tax. They would not be able to claim credit for taxes suppliers pay, and they would be subject to tax on important self-supplied goods and services. (The technical appendix to the government's proposals uses road construction undertaken by a municipality as an example of such self-supply.)

The proposed treatment of nonprofit institutions is a special case of the second approach to exemptions noted earlier. It is complicated by the diversity of nonprofit institutions.

Where such institutions are funded by governments, there is little advantage to restricting the exemption, since the revenue gain in federal sales taxation would be offset by expenditure increases for lower levels of government. While the federal government would benefit by having part of its deficit shifted to the provinces, the end result would be higher provincial or local taxes.

For government-funded educational and cultural institutions and hospitals, it would be better to continue the current exemption of purchases. This could be implemented either through exempting sales to such institutions (as is currently done under the MST) or through refunding taxes they pay on purchases (as is currently done under provincial retail sales taxes). Maintaining the current exempt status of these nonprofit institutions also would imply dropping the government's proposals for self-assessed taxes on imported and self-supplied services that they use.

Many other nonprofit organizations, such as clubs, are agencies for personal consumption. For these institutions, it is appropriate that the goods they purchase be subject to tax.

### *Real Estate*

The government's proposals for taxing commercial real estate transactions generally parallel those for other goods and services. The VAT would apply to the sale or rental of commercial real estate, but taxes paid by vendors would be creditable to purchasers. This would simplify the administration of the tax by identifying potential taxpayers and reducing the gains from tax evasion.

The proposals for residential real estate are more complex. Residential rentals would be exempt, as would be the resale of used residential or personal-use buildings, except where input tax credits had previously been claimed for acquisition costs or capital improvements. Sales of new residential buildings would be taxable, however, and no input tax credits would be allowed to purchasers of owner-occupied homes. The government's proposals are silent on the treatment of residential property where land is sold by way of subdivision, but presumably the rules set out for personal-use property also should apply in this case so that subdivided land is taxed on sale.

The proposals for residential real estate represent a compromise. Their long-term effect would be to tax the capital value of the housing stock, thus indirectly taxing the services the stock provides. Since the existing capital stock would be exempt, however, this long-term result would be approached only gradually. The taxation of new buildings and renovations would reflect the existing taxation of building supplies, so there would be relatively little change in effective tax rates on new construction. The compromise would avoid windfall losses for existing homeowners as well as the politically symbolic taxation of residential rents. It is probably the best approach of all those that are politically feasible.

### *Farms*

The government's proposals would treat farms in the same way as any other business. Farm products would be taxed on sale, and farmers would receive input tax credits on taxed purchases. Sales of nonresidential farm property would be taxable, but the tax would be creditable to farmers purchasing such property.

There would be difficulties in distinguishing between farm property and farm residences. The latter would be exempt if owner-occupied, and presumably would be defined to include a surrounding hectare of "residential use" land. Apparent anomalies would arise, however, concerning farm

property sold to hobby farmers or vice versa, since the sale of hobby farms would not be taxable and input tax credits would not occur on purchases of hobby farms by working farmers. In theory, while prices should adjust on such transactions to reflect the differing treatment of the two types of farms, uncertainty could arise as to whether a purchaser was eligible for input tax credits on tax paid by the seller. Since it generally would be advantageous to claim credits on purchases of hobby farms expected to be held for many years, it might be necessary to promulgate arbitrary rules to classify purchasers as either working farmers or hobby farmers at the date of purchase.

The taxation of farmers could be simplified substantially if food were exempt. In this case, since all farm products are either consumed as food, sold for export, or sold to other businesses, there would be no advantage to subjecting farmers to tax. Farm products that are neither consumed by households as food nor exported would be correctly treated since input tax credits would not be available to purchasers. Business inputs purchased by farmers should remain eligible for tax credits. In addition, sales of farm property could be exempt from tax provided that such properties were not subdivided for sale.

### *Imported Nonfinancial Services*

It would not be practical to attempt to tax imported services directly. Instead, they could be taxed indirectly by not permitting input tax credits on purchases of imported services, so long as the purchaser were a taxable business. It would be difficult, however, to find a way of taxing imported services if the purchaser were a household. The government proposes, in such cases, to subject the purchaser to tax on the cost of the imported service on a self-assessment basis. Such a tax would be difficult to enforce and in many cases would never be collected. Nevertheless, services imported by consumers should be taxed in principle. Recognizing the enforcement difficulties, the best approach probably would be to subject imported services to tax only if the cost of an imported service exceeded a specified limit — say, $1,000.

### *A General Comment*

The principle guiding the above discussion of implementation problems is that a new VAT should tax domestic consumption expenditures of Canadian households as uniformly as possible. The focus on total household consumption should rule out including investment returns in the base of the tax,

and so should rule out taxing financial services. This focus should also rule out extending the tax to goods and services purchased by nonprofit educational and cultural institutions and hospitals, particularly since the revenue gain from so doing would be largely illusory.

Although the base of a VAT should be as broad as possible, some exemptions would be inevitable. While it would be tempting to try to limit such exemptions indirectly, the disadvantages of doing so through denying tax credits on business inputs attributable to exempt sales would outweigh the advantages. The best way to limit the distorting effects of exemptions would be to keep the range of exempt goods and services as narrow as possible. Trying to limit the effect of the exemptions through other means would cause undesirable side effects.

## Potential Transition Problems

The major transitional problem of sales tax reform is macroeconomic, and concerns its effect on wage inflation. An important concern is that sales tax reform initially would increase prices, particularly to the extent that sales taxes were increased to pay for low-income tax credits and a reduction of personal tax rates. If such price increases were reflected in wage increases, thus driving up costs and prices still further, there is a danger that sales tax reform could renew inflationary pressures.

The initial increase in prices might be illusory if it were offset by increases in after-tax income resulting from personal income tax reductions. For this reason, it would be useful if Statistics Canada were to produce a Taxes and Prices Index, which would measure the change in average after-tax real disposable income as well adjust the Consumer Price Index component.

Although a universal VAT is preferable to one with exemptions on other grounds, a VAT with exemptions would reduce the danger of transient inflationary pressures. Part of the concern over price impacts is that the retail, tax-inclusive prices of products on which taxes are reduced (such as manufactured goods) might not fully reflect the price reduction. Continuing to exempt food and rent would mean a smaller shift in taxes among products than would otherwise be the case, and so would mean a smaller potential aggregate price change attributable to asymmetric short-run price adjustments.

It is difficult to implement a significant tax shift without some macroeconomic impact. In the case of sales tax reform, some upward pressure on prices is inevitable in the very short run. The extent of such pressure, however, would be alleviated by likely exemptions to the new tax, and could

be alleviated further by a greater public understanding of the offsetting benefits of accompanying personal income tax reductions.

## Conclusion

Sales tax reform is highly desirable. The proposal to postpone it to the second stage of tax reform is unfortunate, however, as it leaves the nature of such reform unclear.

Sales tax reform is unlikely to be implemented if fears of the uncertain redistributive effects of differing sales tax alternatives become a major issue in the next election campaign. It would be far better to settle the issue by implementing a less than ideal version of a VAT that is acceptable to most members of the public than to hold out for a "better" alternative that may never be adopted.

It would be better to implement immediately a federal VAT that exempted food and drugs and that was accompanied by a refundable tax credit for low-income households. If it is possible to get the provinces to agree expeditiously to an integrated federal-provincial VAT, the legislation should be modified to provide for this. But the federal government's desire to achieve the clear advantages of a national sales tax should be integrated into an implementation strategy that permits speedy resolution of sales tax reform issues.

As with any new tax, there will be inevitable arguments over issues that concern particular business sectors and institutions. This paper has commented on some specific implementation issues on which the government's proposals should be modified. But argument over details should not be permitted to obscure the main issue: sales tax reform is essential. Any one of the government's proposals would be far preferable to the existing manufacturers' sales tax.

The issue of whether food and/or other "necessities" should be exempt is of secondary importance to the overriding goal of sales tax reform. That goal would be achieved by moving the federal sales tax to the retail level, by eliminating perverse subsidies on imports and taxes on exports, and by broadening the tax base. Beyond this, the achievement of the advantages of a uniform sales tax is desirable but not as important.

The integration of federal and provincial sales taxes is also desirable, on both economic and political grounds. But this can be the aim of a second stage of sales tax reform. The first stage should aim to make federal sales taxation fairer, less arbitrary, and less of a burden on the economy. This first stage should not be postponed.

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In this study, six leading economists and tax experts evaluate the impact of the proposed reforms on individual taxpayers, on businesses, on government finances, and on Canada's international tax competitiveness.

The authors agree that the *White Paper's* proposals are in the right direction. At the same time, they caution that the reform process will be incomplete and the economic benefits will be reduced if the government fails to take early steps to reform the federal sales tax.

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